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American Institute of Certified Public Accountants. Not-for-Profit Organizations Committee

AICPA AUDIT AND ACCOUNTING GUIDE

AICPA

American Institute of Certified Public Accountants

Not-for-Profit Organizations

With Conforming Changes as of May 1, 1998

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

NOT-FOR-PROFIT ORGANIZATIONS

With Conforming Changes as of May 1, 1998

This edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, which was originally issued in 1996, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page v). The changes made are identified in a schedule in appendix F of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This AICPA Audit and Accounting Guide has been prepared by the AICPA Not-for-Profit Organizations Committee to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the Financial Accounting Standards Board. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

The AICPA Auditing Standards Board has found the descriptions of auditing standards, procedures, and practices in this Audit and Accounting Guide to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. Descriptions of auditing standards, procedures, and practices in Audit and Accounting Guides are not as authoritative as pronouncements of the Auditing Standards Board, but AICPA members should be aware that they may have to justify a departure from such descriptions if the quality of their work is questioned.

David B. Kaplan, *Chair*
Accounting Standards Executive Committee

Deborah Lambert, *Chair*
Auditing Standards Board

Not-for-Profit Organizations Committee (1995-1996)

Not-for-Profit Organizations Committee (1996-1997)

AICPA Staff

The Not-for-Profit Organizations Committee gratefully acknowledges the contributions made to the development, content, and writing of this Audit and Accounting Guide by Alan S. Glazer, Professor of Business Administration, Franklin and Marshall College, and Henry R. Jaenicke, C.D. Clarkson Professor of Accounting, Drexel University.

In developing this Audit and Accounting Guide, the AICPA Not-for-Profit Organizations Committee considered guidance included in the following authoritative pronouncements through May 1, 1998:

- FASB Statements through Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statements No. 87, 88, and 106
- FASB Interpretations through Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (an interpretation of FASB Statement No. 116)
- FASB Technical Bulletins (TB) through TB 97-1, *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*
- AICPA Statements of Position (SOP) through SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- AICPA Practice Bulletins (PB) through PB 15, *Accounting by the Issuer of Surplus Notes*
- Consensus positions of the FASB's Emerging Issues Task Force reached through January 1998
- AICPA Statements on Auditing Standards (SAS) through SAS No. 85, *Management Representations*
- AICPA Statements on Standards for Attestation Engagements (SSAE) through SSAE No. 7, *Establishing an Understanding With the Client*

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

Preface

Purpose

This AICPA Audit and Accounting Guide (Guide) has been prepared to assist nongovernmental not-for-profit organizations in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors in auditing and reporting on those financial statements.

Applicability

This Guide applies to organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made.*

Limitations

This Guide does not discuss the application of all GAAP and all generally accepted auditing standards (GAAS) that are relevant to the preparation and audit of financial statements of not-for-profit organizations. This Guide is directed primarily to those aspects of the preparation and audit of not-for-profit organizations' financial statements that are unique to those organizations or are considered particularly significant to them.

Impact on Other Literature

This Guide incorporates certain provisions of FASB Statement Nos. 116 and 117, *Financial Statements of Not-for-Profit Organizations.* Not all guidance that is included in those Statements, however, is incorporated, repeated, or summarized in this Guide. Accordingly, those Statements should be read in conjunction with this Guide. Like FASB Statement Nos. 116 and 117, this Guide is directed at not-for-profit organizations in general, and not at specific kinds of such organizations, such as voluntary health and welfare organizations or private colleges and universities. It is expected that various industry associations will publish guidance on applying both the FASB Statements and this Guide to specific kinds of organizations.[1]

This Guide supersedes the following AICPA Audit and Accounting Guides:[2]

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[1] Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), establishes a hierarchy of sources of GAAP. The hierarchy is described in appendix G [paragraph 1.30] to chapter 1, "Introduction," of this Guide. SAS No. 69 notes that in the absence of established accounting principles described in categories (a)–(d) of the hierarchy of GAAP, the auditor may consider other accounting literature, including pronouncements of other professional associations, depending on its relevance in the circumstances. Guidance published by industry associations may be considered "other accounting literature" in the hierarchy of sources of accounting principles established by SAS No. 69.

[2] As noted previously in this Preface, this Guide applies to nongovernmental not-for-profit organizations. (Paragraph 1.03 of this Guide discusses the determination of whether an entity is a nongovernmental organization.) Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities,* provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statement Nos. 116 and 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in Statement of Position (SOP) 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or the Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*

(continued)

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also supersedes the following AICPA SOPs:

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*[3]
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

Effective Date and Transition

The provisions of this Guide, other than those included in paragraphs 1.06 through 1.17, which are discussed below, are effective for financial statements for fiscal years ending on or after December 31, 1996.[4] Earlier application is permitted.

The provisions included in paragraphs 1.06 through 1.17 are effective for financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is fiscal years beginning after December 15, 1995. Earlier application is permitted.

(footnote continued)

(modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.

GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models,* requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities,* as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities,* and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.) The applicability of the Industry Audit Guide *Audits of Colleges and Universities* and SOP 74-8 to governmental colleges and universities that use the "AICPA College Guide Model" is unchanged by this Guide.

[3] This Guide supersedes SOP 87-2, because the provisions of SOP 87-2 are incorporated into paragraphs 13.31 through 13.40 of this Guide. On March 11, 1998, the AICPA issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, which is included as appendix C to this Guide. SOP 98-2 is effective for financial statements for years beginning on or after December 15, 1998, with earlier application encouraged. SOP 98-2 amends paragraphs 13.17, 13.19, 13.20, and 13.31 through 13.40 of this Guide. Those amendments will be reflected in conforming changes made to this Guide prior to the effective date of SOP 98-2.

[4] This Guide does not defer the effective date of any pronouncements that cover not-for-profit organizations.

Unless the provisions of this Guide, other than those included in paragraphs 1.06 through 1.17, are applied retroactively under the provisions of the following paragraph, the effect of initially applying this Guide should be reported as the effect of a change in accounting principle, in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes*, paragraph 19). The amount of the cumulative effect should be based on a retroactive computation. Organizations should report the cumulative effect of a change in accounting on each class of net assets in the statement of activities, after the caption "extraordinary items" (if any) and before the captions "change in unrestricted net assets," "change in temporarily restricted net assets," and "change in permanently restricted net assets."

This Guide, other than the guidance in paragraphs 1.06 through 1.17, may be applied retroactively by restating the opening net assets for the earliest year presented or for the year this Guide is first applied if no prior years are presented. In the period in which this Guide is first applied, organizations should disclose the nature of any restatement and its effect on the change in net assets for each period presented.

In implementing the guidance in paragraphs 1.06 through 1.17, which incorporates the provisions of SOP 94-2 into this Guide, the transition rules of the APB Opinions and FASB Statements adopted, other than their effective dates, should be followed. However, if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.06 through 1.17, organizations have the option of including the cumulative effect of adopting those accounting principles in the statement of activities in the year this Guide is adopted, regardless of the transition rules of the APB Opinions and FASB Statements adopted,[5] and the financial statements should disclose the nature of the cumulative adjustment. (Paragraphs 19 and 20 of APB Opinion No. 20 discuss reporting the cumulative effects of changes in accounting principles.) In circumstances in which there is more than one change in accounting principle resulting from applying this Guide and the cumulative effect of adopting those accounting principles is included in the statement of changes in net assets in the year the guidance in paragraphs 1.06 through 1.17 is adopted, this Guide does not require the pro forma disclosures required by paragraphs 19(d) and 21 of APB Opinion No. 20.

[5] Organizations that adopt the guidance in paragraphs 1.06 through 1.17 in the same year in which they adopt FASB Statement No. 116 are permitted to apply the provisions of paragraph 17 of that Statement, concerning recognition of expirations of restrictions, prospectively, as specified in that Statement, regardless of whether they report the cumulative effect of adopting other accounting principles as a result of applying the guidance in paragraphs 1.06 through 1.17 of this Guide.

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Chapter 1
Introduction

Scope

1.01 This Audit and Accounting Guide (Guide) covers organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*. That definition is as follows:

> An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (Concepts Statement No. 4, paragraph 7).

As noted in the above definition, not-for-profit organizations have characteristics (*a*), (*b*), and (*c*) in varying degrees. An organization could meet the definition of a not-for-profit organization without possessing characteristic (*a*), (*b*), or (*c*). For example, some not-for-profit organizations, such as those that receive all their revenue from exchange transactions, receive no contributions.

1.02 The term *not-for-profit organizations* encompasses all entities defined as not-for-profit organizations by FASB Statement No. 116, including the kinds of organizations that were covered by the AICPA Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities*, the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*, and American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, which are superseded by this Guide. Accordingly, this Guide applies to nongovernmental not-for-profit organizations of the following kinds:[1]

- Cemetery organizations
- Civic and community organizations
- Colleges and universities
- Elementary and secondary schools

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[1] This list does not necessarily include all organizations that meet the definition of a not-for-profit organization in FASB Statement No. 116. This Guide applies to all organizations that meet the definition, regardless of whether they are included in this list.

- Federated fund-raising organizations
- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural organizations
- Performing arts organizations
- Political parties
- Political action committees
- Private and community foundations
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations
- Social and country clubs
- Trade associations
- Voluntary health and welfare organizations
- Zoological and botanical societies

1.03 Paragraph 1.02 provides that this Guide applies to certain nongovernmental not-for-profit organizations. Nongovernmental organizations are all organizations other than governmental organizations. Public corporations[2] and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;

b. The potential for unilateral dissolution by a government with the net assets reverting to a government; or

c. The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

1.04 Not-for-profit organizations that are providers of health care services[3] are not covered by this Guide and should follow the AICPA Audit and Accounting Guide *Health Care Organizations*.

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[2] *Black's Law Dictionary* defines a public corporation as: An artificial person (e.g.,[a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state. Sharon Realty Co. v. Westlake, Ohio Com. Pl., 188 N.E.2d 318, 323, 25 O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. York County Fair Ass'n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362.

[3] Providers of health care services that meet the definition of a voluntary health and welfare organization in FASB Statement No. 116 should follow this Guide.

GAAP Hierarchy for Not-for-Profit Organizations

1.05 AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411), states that the guidance provided by FASB Statements and Interpretations, Opinions of the Accounting Principles Board (APB), and Accounting Research Bulletins (ARB) shall be considered established accounting principles pursuant to Rule 203 of the AICPA Code of Professional Conduct. (Appendix G [paragraph 1.30] of this chapter discusses SAS No. 69 and the hierarchy of sources of generally accepted accounting principles [GAAP].)

1.06 Not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations unless the specific pronouncement explicitly exempts not-for-profit organizations or their subject matter precludes such applicability. (As noted in paragraphs 1.11 and 1.12 of this Guide, not-for-profit organizations should follow the guidance in Statement Nos. 116 and 117, *Financial Statements of Not-for-Profit Organizations,* and this Guide in applying the guidance in pronouncements listed in appendixes C and D [paragraphs 1.26 and 1.27] of this chapter.)

1.07 The appendixes [paragraphs 1.24 through 1.30] of this chapter are aids to the implementation of the guidance in this chapter.

1.08 Pronouncements issued by the FASB subsequent to this Guide's effective date apply to not-for-profit organizations unless those pronouncements explicitly exempt not-for-profit organizations or their subject matter precludes such applicability.[4]

1.09 Not-for-profit organizations may follow and are not prohibited from following the guidance in effective provisions of the APB Opinions and the FASB Statements and Interpretations listed in appendix A [paragraph 1.24] of this chapter, which specifically exempt not-for-profit organizations from their application, unless FASB Statement Nos. 116 or 117 or this Guide provide different guidance. (However, the guidance included in the effective provisions of pronouncements listed in appendix A [paragraph 1.24] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities.) The discussion in paragraphs 1.11 through 1.17 of this Guide should be considered in determining the hierarchy of such guidance and of guidance issued by the AICPA.

1.10 Certain financial reporting guidance listed in appendix B [paragraph 1.25] of this chapter, such as that concerning common stock and convertible debt, generally does not apply to the kinds of entities covered by this Guide, because such entities do not enter into the kinds of transactions covered by that guidance. (However, the guidance included in the effective provisions of pronouncements included in appendix B [paragraph 1.25] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities. Also, not-for-profit organizations should follow the effective provisions of pronouncements in appendix B [paragraph 1.25] if they enter into the kinds of transactions covered by that guidance.)

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[4] The guidance in paragraphs 1.05 through 1.17 of this Guide addresses only the pronouncements listed in paragraph 1.06. However, not-for-profit organizations are also subject to other pronouncements included in categories (b)-(d) of paragraph 5 of SAS No. 69 and should apply AICPA Audit and Accounting Guides, SOPs, and Practice Bulletins and FASB Technical Bulletins and the consensus positions of the FASB Emerging Issues Task Force that apply to them. (Appendix G [paragraph 1.30] of this chapter discusses SAS No. 69 and the GAAP hierarchy.)

1.11 Other pronouncements, which are listed in appendix C [paragraph 1.26] of this chapter (ARB No. 51, *Consolidated Financial Statements*, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*), do not exempt not-for-profit organizations from their scope, but the transactions they contemplate also are covered by FASB Statement No. 116 and this Guide. Statement Nos. 116 and 117 and this Guide provide guidance for applying the pronouncements to circumstances unique to not-for-profit organizations and not contemplated by the pronouncements and therefore should be followed to apply the guidance in those pronouncements to not-for-profit organizations. (However, the guidance included in the effective provisions of pronouncements included in appendix C [paragraph 1.26] should be followed by all for-profit entities owned, whether owned all or in part, by not-for-profit entities.)

1.12 Some pronouncements (listed in appendix D [paragraph 1.27] of this chapter), which may include guidance concerning the recognition and measurement of assets, liabilities, revenues, expenses, gains and losses, and financial statement display, state that their provisions apply only to entities operating in certain industries. Such entities generally are business enterprises. An example of such guidance is FASB Statement No. 63, *Financial Reporting by Broadcasters*. However, some not-for-profit organizations conduct activities[5] in some of those industries and should apply the guidance in the pronouncements concerning the recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses to the transactions unique to those industries. However, such not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117 and this Guide, even though it may conflict with display that would result from applying the guidance in the pronouncements listed in appendix D [paragraph 1.27].

1.13 Financial reporting pronouncements that have not been superseded and are not included in appendixes A through D [paragraphs 1.24 through 1.27] of this chapter are listed in appendix E [paragraph 1.28] of this chapter. Not-for-profit organizations should follow the effective provisions of the pronouncements listed in appendix E [paragraph 1.28].[6]

1.14 Certain other pronouncements, although they do not exempt not-for-profit organizations and do cover transactions conducted by not-for-profit organizations, include some provisions whose application by not-for-profit organizations may be unclear. Nevertheless, not-for-profit organizations are required to follow the effective provisions of those pronouncements. These provisions and their applicability are discussed below.

APB Opinion No. 16, *Business Combinations*

1.15 Because the conditions for applying the pooling of interests method of accounting for a business combination generally include an exchange of common stock of the combining entities, not-for-profit organizations generally would not meet the conditions for applying that method. The AICPA Accounting Standards Executive Committee (AcSEC) believes that circumstances exist under which reporting on the combination of two or more not-for-profit organizations (or that of a not-for-profit organization with a formerly for-profit entity) by the pooling of interests method better reflects the substance of the transac-

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[5] Such activities may be conducted by (*a*) for-profit entities owned and consolidated by not-for-profit organizations, (*b*) divisions of not-for-profit organizations, or (*c*) entire not-for-profit organizations, such as those operating as not-for-profit broadcasters.

[6] See footnote 4.

tion than reporting by the purchase method. Therefore, not-for-profit organizations are, under certain circumstances, permitted to report by the pooling of interests method, even though they generally do not issue common stock. Such circumstances include the combination of two or more entities to form a new entity without the exchange of consideration.

1.16 An example of acceptable practice, in some circumstances, for reporting business combinations by not-for-profit organizations if there has been no exchange of consideration is to report the (*a*) assets, (*b*) liabilities, and (*c*) net asset balances of the combined entities as of the beginning of the year and disclose the information that would be required to be disclosed for a pooling of interests under APB Opinion No. 16.

Provisions of Certain Pronouncements Concerning Financial Statement Display

1.17 The following pronouncements include provisions specifying the financial statement display of certain financial statement elements or items such as gains and losses, extraordinary items, translation adjustments, income tax expense, and prepaid or deferred income taxes:

- APB Opinion No. 9, *Reporting the Results of Operations*
- APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*; FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*; and FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities**
- APB Opinion No. 30, as amended by FASB Statement No. 128, *Earnings per Share*
- FASB Statement No. 52, *Foreign Currency Translation*
- FASB Statement No. 109, *Accounting for Income Taxes*

None of the preceding pronouncements considers the net asset reporting model included in FASB Statement No. 117 and this Guide. Therefore, preparers of financial statements of not-for-profit organizations should consider the reporting objectives of these APB Opinions and FASB Statements when exercising judgment about how to best display elements, such as in which net asset class.

Fund Accounting and Net Asset Classes

1.18 Fund accounting is a technique used by some not-for-profit organizations for purposes of internal recordkeeping and managerial control and to help ensure that the use of resources is in accordance with stipulations imposed

* In June 1996, the FASB issued Statement No. 125, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

by donors and other resource providers and with self-imposed limitations designated by the organization's governing board. Under fund accounting, resources are classified into funds associated with specific activities and objectives. Prior to implementing FASB Statement No. 117, some not-for-profit organizations used fund accounting for financial reporting in conformity with applicable AICPA Industry Audit Guides and Audit and Accounting Guides.

1.19 *Montgomery's Auditing* notes that "as used in nonprofit accounting, a fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, the fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to ensure that the limitations and restrictions on the use of resources are observed. Though the fund concept involves separate accounting records, it does not entail the physical segregation of resources. Fund accounting is basically a mechanism to assist in exercising control over the purpose of particular resources and amounts of those resources available for use."[7] Fund accounting is discussed further in chapter 16, "Fund Accounting," of this Guide.

1.20 Paragraph 18, footnote 5, of FASB Statement No. 117 states that "this Statement does not use the terms *fund balance* or *changes in fund balances* because in current practice those terms are commonly used to refer to individual groups of assets and related liabilities rather than to an entity's net assets or changes in net assets taken as a whole...." As discussed in chapter 3, "Basic Financial Statements," of this Guide, FASB Statement No. 117 requires that the amounts for each of three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) be displayed in a statement of financial position and that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

1.21 Therefore, under FASB Statement No. 117, reporting by individual funds or fund groups is not required. FASB Statement No. 117, however, does not preclude providing disaggregated information by individual funds or fund groups, as long as the required aggregated amounts for each of the three classes of net assets are displayed as indicated above. Paragraph 50 of the Statement specifically notes that "...how an organization maintains its internal accounting and recordkeeping systems is a matter outside the purview of the FASB."

1.22 Some not-for-profit organizations may continue to use fund accounting for purposes other than reporting in conformity with GAAP, and some may provide disaggregated information in the financial statements beyond the minimum requirements of FASB Statement No. 117. A particular fund balance may fall completely into one of the three net asset classes or may be allocated to more than one net asset class, in conformity with the requirements of FASB Statement No. 117 and as discussed in chapter 16 of this Guide.

1.23 The accounting and auditing issues concerning each particular asset, liability, or class of net assets (financial statement elements) are not a function of the element's internal classification or financial statement subclassification. Accordingly, this Guide is organized by financial statement elements and not by type of fund or groups of funds. Chapter 16 of this Guide contains a discussion of the relationship of an organization's fund balances to its net asset classes.

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[7] Vincent M. O'Reilly, Murray B. Hirsch, Philip L. Defliese, and Henry R. Jaenicke, *Montgomery's Auditing*, 11th ed. (New York: John Wiley & Sons, 1990), 791.

1.24

Appendix A—Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application

Pronouncement	*Other References, if Any* *	*Status of Other References*
APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock,* as amended by APB Opinions 23 and 30 and FASB Statement Nos. 13, 58, 94, 115, 121, and 128, and including FASB Interpretation No. 35[CON]	SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*[CON]	This Guide provides no guidance for the equity method of accounting for common stock. However, it does provide guidance for accounting for investments in common stock.
APB Opinion 28, *Interim Financial Reporting,* as amended by FASB Statement Nos. 3, 95, 109, 128, 130, and 131, and including FASB Interpretation No. 18	None	None
FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*	None	None

(Continued)

Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application—continued

Pronouncement	*Other References, if Any* *	*Status of Other References*
FASB Statement No. 89, *Financial Reporting and Changing Prices,* as amended by FASB Statement No. 109[CON]	None	None
FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* as amended by FASB Statement Nos. 124, 125, and 130**	FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; Chapter 8 of this Guide	Currently effective
FASB Statement No. 128, *Earnings per Share*	None	None
FASB Statement No. 130, *Reporting Comprehensive Income*	FASB Statement No. 117	Currently effective
FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*	None	None
FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, as amended by FASB Statement Nos. 71, 109, and 111	None	None
FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*	See APB Opinion 18	See APB Opinion 18

* References in this column are provided as a guide to other sources of information about the topic covered by the listed pronouncement.

[CON] On October 16, 1995, the FASB released an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Policy and Procedures*, that would supersede ARB No. 51 and FASB Statement No. 94, and would amend APB Opinions 16, 17, 18, and 29, and FASB Statement Nos. 5, 14, 15, 37, 57, and 89, and provide guidance that differs from guidance included in SOP 94-3.

**In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

1.25

Appendix B—Financial Reporting Pronouncements That, by the Nature of Their Subject Matter, Generally Do Not Apply to Not-for-Profit Organizations

- APB Opinion 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
- APB Opinion 25, *Accounting for Stock Issued to Employees*, as amended by FASB Statement Nos. 109 and 123, and including FASB Interpretation Nos. 28 and 38
- FASB Statement No. 84, *Induced Conversions of Convertible Debt*
- FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as amended by FASB Statement No. 128
- FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, as amended by FASB Statement Nos. 123 and 128
- FASB Interpretation No. 38, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*, as amended by FASB Statement Nos. 123 and 128

1.26

Appendix C—Financial Reporting Pronouncements Whose Application to Not-for-Profit Organizations is Subject to Additional FASB or AICPA Guidance

Pronouncement	*Additional Guidance*
ARB No. 51, *Consolidated Financial Statements*, as amended by APB Opinions 10, 16, 18, and 23, and FASB Statement Nos. 58, 71, 94, 111, and 131[CON]	SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*[CON]
APB Opinion 29, *Accounting for Nonmonetary Transactions*, as amended by FASB Statement Nos. 71, 109, and 123, and including FASB Interpretation No. 30[CON]	FASB Statement No. 116 and chapter 5 of this Guide provide accounting guidance for contributions
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, as amended by FASB Statement No. 131[CON]	See ARB No. 51
FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, including FASB Interpretation No. 42[AGT]	This Guide
FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, as amended by FASB Statement No. 124	This Guide
FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*	This Guide
FASB Interpretation No. 30, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets*, as amended by FASB Statement No. 109	See APB Opinion 29
FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*	This Guide

[AGT] On December 29, 1995, the FASB released an exposure draft of a proposed FASB Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*.

[CON] On October 16, 1995, the FASB released an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Policy and Procedures*, that would supersede ARB No. 51 and FASB Statement No. 94, and would amend APB Opinions 16, 17, 18, and 29, and FASB Statement Nos. 5, 14, 15, 37, 57, and 89, and provide guidance that differs from guidance included in SOP 94-3.

1.27

Appendix D—Financial Reporting Pronouncements Pertaining to Specialized Industry Practices of Business Enterprises

This appendix includes pronouncements that apply only to entities operating in certain industries, generally business enterprises. However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses in those pronouncements to the transactions unique to those industries. In addition, those not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, and this Guide, although it may conflict with display that would result from applying the guidance in the pronouncements included in this appendix.

- APB Opinion 12, *Omnibus Opinion—1967* (guidance under the heading "Capital Changes")
- APB Opinion 13, *Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks*
- FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, as amended by FASB Statement Nos. 71 and 95, and including FASB Interpretation No. 7
- FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended by FASB Statement Nos. 25, 69, 71, 109, and 121, and including FASB Interpretation Nos. 33 and 36
- FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (an amendment of FASB Statement No. 19)*, as amended by FASB Statement No. 111
- FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statement Nos. 75 and 110
- FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers (an amendment of Chapter 5 of ARB No. 43 and an Interpretation of APB Opinions 17 and 30)*, as amended by FASB Statement No. 109
- FASB Statement No. 45, *Accounting for Franchise Fee Revenue*
- FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*
- FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, as amended by FASB Statement Nos. 71, 121, and 131
- FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended by FASB Statement Nos. 91, 97, 109, 113, 114, 115, 120, 121, and 124, and including FASB Interpretation No. 40
- FASB Statement No. 61, *Accounting for Title Plant*, as amended by FASB Statement No. 121
- FASB Statement No. 63, *Financial Reporting by Broadcasters*

- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended by FASB Statement Nos. 91, 115, 124, and 125*
- FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, as amended by FASB Statement Nos. 111 and 121
- FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities (an amendment of FASB Statements 19, 25, 33, and 39)*, as amended by FASB Statement Nos. 89, 95, 109, and 131
- FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, as amended by FASB Statement Nos. 90, 92, 109, and 121
- FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions (an amendment of APB Opinion No. 17, an interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9)*
- FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures (an amendment of APB Opinion No. 20)*
- FASB Statement No. 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units (an amendment of FASB Statement No. 35)*
- FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs (an amendment of FASB Statement No. 71)*, as amended by FASB Statement Nos. 92 and 109
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17)*, as amended by FASB Statement Nos. 98, 114, 115, and 124
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans (an amendment of FASB Statement No. 71)*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as amended by FASB Statement Nos. 113, 115, and 120
- FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, as amended by FASB Statement Nos. 109 and 121
- FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts (an amendment of FASB Statement No. 35)*
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, as amended by FASB Statement No. 120, and including FASB Interpretation No. 40
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (an amendment of FASB Statement Nos. 60, 97, and 113 and Interpretation No. 40)*
- FASB Interpretation No. 7, *Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises*

- FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*, as amended by FASB Statement No. 72
- FASB Interpretation No. 33, *Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method*
- FASB Interpretation No. 36, *Accounting for Exploratory Wells in Progress at the End of a Period*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, as amended by FASB Statement Nos. 115 and 120

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* In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

1.28

Appendix E—Financial Reporting Pronouncements Not Subsequently Superseded and Not Included in Appendixes A through D of This Chapter

As stated in paragraph 1.06 of this Guide, not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations, except for specific pronouncements that explicitly exempt not-for-profit organizations and pronouncements for which this Guide provides guidance. This appendix includes pronouncements, not subsequently superseded, that (*a*) do not exempt not-for-profit organizations from their application, (*b*) by the nature of their subject matter, apply to the kinds of transactions not-for-profit organizations engage in, (*c*) are subject to no additional FASB or AICPA guidance, and (*d*) do not pertain to specialized industry practices of business enterprises. Not-for-profit organizations should follow the guidance in the effective provisions of the pronouncements included in this appendix.

- ARB No. 43, *Restatement and Revision of Accounting Research Bulletins,* as amended by APB Opinions 6, 9, 10, 16, 17, 20, 21, 25, and 26, and FASB Statement Nos. 5, 6, 44, 52, 78, 94, 109, 111, 115, 123, and 131
- ARB No. 45, *Long-Term Construction-Type Contracts*
- ARB No. 46, *Discontinuance of Dating Earned Surplus*
- APB Opinion 2, *Accounting for the "Investment Credit,"* as amended by APB Opinion 4 and FASB Statement Nos. 71 and 109
- APB Opinion 4 (amending Opinion 2), *Accounting for the "Investment Credit"*
- APB Opinion 6, *Status of Accounting Research Bulletins*, as amended by APB Opinions 16, 17, and 26, and FASB Statement Nos. 52, 71, 109, and 111
- APB Opinion 9, *Reporting the Results of Operations* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by APB Opinions 13, 15, 20, and 30, and FASB Statement No. 16
- APB Opinion 10, *Omnibus Opinion—1966,* as amended by APB Opinions 12, 14, 16, and 18, and FASB Statement Nos. 111 and 129, and including FASB Interpretation Nos. 39 and 41
- APB Opinion 12, *Omnibus Opinion—1967* (except guidance under the heading, "Capital Changes"), as amended by APB Opinion 14 and FASB Statement Nos. 87, 106, and 111
- APB Opinion 16, *Business Combinations* (paragraph 1.15 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 10, 38, 71, 79, 87, 106, 109, and 121, and including FASB Interpretation Nos. 4, 9, and 21[CON]
- APB Opinion 17, *Intangible Assets,* as amended by APB Opinion 30 and FASB Statement Nos. 2, 71, 72, 109, and 121, and including FASB Interpretation No. 9[CON]
- APB Opinion 20, *Accounting Changes,* as amended by FASB Statement Nos. 16, 58, 71, 73, 95, 111, and 128, and including FASB Interpretation Nos. 1 and 20

- APB Opinion 21, *Interest on Receivables and Payables*, as amended by FASB Statement Nos. 34 and 109
- APB Opinion 22, *Disclosure of Accounting Policies*, as amended by FASB Statement Nos. 2, 52, 95, and 111
- APB Opinion 23, *Accounting for Income Taxes—Special Areas*, as amended by FASB Statement Nos. 60, 71, 94, and 109
- APB Opinion 26, *Early Extinguishment of Debt* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by APB Opinion 30 and FASB Statement Nos. 4, 15, 71, 84, and 125*
- APB Opinion 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 4, 16, 60, 97, 101, 109, and 128, and including FASB Interpretation No. 27
- FASB Statement No. 2, *Accounting for Research and Development Costs*, as amended by FASB Statement Nos. 71 and 86, and including FASB Interpretation Nos. 4 and 6
- FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt* (an amendment of APB Opinion No. 30) (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 64 and 71
- FASB Statement No. 5, *Accounting for Contingencies*, as amended by FASB Statement Nos. 11, 16, 60, 71, 87, 111, 112, 113, 114, and 123, and including FASB Interpretation Nos. 14 and 34[CON]
- FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced (an amendment of ARB No. 43, Chapter 3A)*, and including FASB Interpretation No. 8
- FASB Statement No. 10, *Extension of "Grandfather" Provisions for Business Combinations (an amendment of APB Opinion No. 16)*
- FASB Statement No. 11, *Accounting for Contingencies—Transition Method (an amendment of FASB Statement No. 5)*
- FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement Nos. 22, 23, 27, 28, 29, 34, 71, 91, 94, 98, 109, and 125,* and including FASB Interpretation Nos. 19, 21, 23, 24, 26, and 27
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statement Nos. 71, 111, 114, and 121[CON]
- FASB Statement No. 16, *Prior Period Adjustments*, as amended by FASB Statement Nos. 71 and 109
- FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)*, as amended by FASB Statement Nos. 71 and 125*
- FASB Statement No. 23, *Inception of the Lease (an amendment of FASB Statement No. 13)*
- FASB Statement No. 27, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)*

- FASB Statement No. 28, *Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)*, as amended by FASB Statement No. 66
- FASB Statement No. 29, *Determining Contingent Rentals (an amendment of FASB Statement No. 13)*, as amended by FASB Statement No. 98
- FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statement Nos. 42, 58, 62, 71, and 121, and including FASB Interpretation No. 33
- FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes (an amendment of APB Opinion No. 11)*, as amended by FASB Statement No. 109[CON]
- FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises (an amendment of APB Opinion No. 16)* (paragraph 1.15 of this Guide discusses this pronouncement), as amended by FASB Statement No. 109
- FASB Statement No. 42, *Determining Materiality for Capitalization of Interest Cost (an amendment of FASB Statement No. 34)*
- FASB Statement No. 43, *Accounting for Compensated Absences*, as amended by FASB Statement Nos. 71, 112, and 123
- FASB Statement No. 47, *Disclosure of Long-Term Obligations*
- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- FASB Statement No. 49, *Accounting for Product Financing Arrangements*, as amended by FASB Statement No. 71
- FASB Statement No. 52, *Foreign Currency Translation* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 95, 109, and 130, and including FASB Interpretation No. 37
- FASB Statement No. 57, *Related Party Disclosures*, as amended by FASB Statement Nos. 95 and 109[CON]
- FASB Statement No. 58, *Capitalization of Interest in Financial Statements That Include Investments Accounted for by the Equity Method (an amendment of FASB Statement No. 34)*
- FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants (an amendment of FASB Statement No. 34)*
- FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements (an amendment of FASB Statement No. 4)*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*, as amended by FASB Statement Nos. 98 and 121
- FASB Statement No. 68, *Research and Development Arrangements*
- FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, as amended by FASB Statement Nos. 105 and 125[*]
- FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor (an amendment of ARB No. 43, Chapter 3A)*
- FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises (an amendment of APB Opinion No. 16)* (paragraph 1.15 of this Guide discusses this pronouncement)

- FASB Statement No. 80, *Accounting for Futures Contracts*, as amended by FASB Statement Nos. 115 and 130
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- FASB Statement No. 87, *Employers' Accounting for Pensions*, as amended by FASB Statement Nos. 106, 109, 130, and 132
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, as amended by FASB Statement No. 132
- FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, as amended by FASB Statement No. 99
- FASB Statement No. 95, *Statement of Cash Flows*, as amended by FASB Statement Nos. 102, 104, and 117
- FASB Statement No. 98, *Accounting for Leases:*
  - *Sale-Leaseback Transactions Involving Real Estate*
  - *Sales-Type Leases of Real Estate*
  - *Definition of the Lease Term*
  - *Initial Direct Costs of Direct Financing Leases*

  (an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11)
- FASB Statement No. 99, *Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations (an amendment of FASB Statement No. 93)*
- FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (an amendment of FASB Statement No. 95)*, as amended by FASB Statement No. 115
- FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions (an amendment of FASB Statement No. 95)*
- FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement Nos. 107, 111, 119, 123, and 125, and including FASB Interpretation No. 39*
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, as amended by FASB Statement No. 132
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 112, 119, 123, 125, and 126*
- FASB Statement No. 109, *Accounting for Income Taxes* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 115, 123, and 130
- FASB Statement No. 111, *Rescission of FASB Statement No. 32 and Technical Corrections*
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits (an amendment of FASB Statements No. 5 and 43)*, as amended by FASB Statement No. 123

- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment of FASB Statements No. 5 and 15)*, as amended by FASB Statement No. 118
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (an amendment of FASB Statement No. 114)*
- FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
- FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended by FASB Statement No. 127*
- FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*
- FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125**
- FASB Statement No. 129, *Disclosure of Information about Capital Structure*
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*
- FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory*, as amended by FASB Statement No. 121
- FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*
- FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, as amended by FASB Statement No. 86
- FASB Interpretation No. 8, *Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*
- FASB Interpretation No. 20, *Reporting Accounting Changes under AICPA Statements of Position*, as amended by FASB Statement No. 111
- FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*
- FASB Interpretation No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*
- FASB Interpretation No. 24, *Leases Involving Only Part of a Building*
- FASB Interpretation No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease*
- FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*
- FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*
- FASB Interpretation No. 37, *Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity*

- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, as amended by FASB Statement No. 113 and FASB Interpretation No. 41
- FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*

[CON] On October 16, 1995, the FASB released an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Policy and Procedures*, that would supersede ARB No. 51 and FASB Statement No. 94, and would amend APB Opinions 16, 17, 18, and 29, and FASB Statement Nos. 5, 14, 15, 37, 57, and 89, and provide guidance that differs from guidance included in SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*.

* In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

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Appendix F—All Financial Reporting Pronouncements, Cross-Referenced by Appendix

Pronouncement	*Appendix*
ARB 1 to ARB 42	Superseded
ARB 43	E
ARB 44	Superseded
ARB 44 (Revised)	Superseded
ARB 45	E
ARB 46	E
ARB 47 to ARB 50	Superseded
ARB 51	C
APB Opinion 1	Superseded
APB Opinion 2	E
APB Opinion 3	Superseded
APB Opinion 4	E
APB Opinion 5	Superseded
APB Opinion 6	E
APB Opinions 7 and 8	Superseded
APB Opinion 9	E
APB Opinion 10	E
APB Opinion 11	Superseded
APB Opinion 12	D, E
APB Opinion 13	D
APB Opinion 14	B
APB Opinion 15	Superseded
APB Opinion 16	E
APB Opinion 17	E
APB Opinion 18	A
APB Opinion 19	Superseded
APB Opinion 20	E
APB Opinion 21	E
APB Opinion 22	E
APB Opinion 23	E
APB Opinion 24	Superseded
APB Opinion 25	B
APB Opinion 26	E
APB Opinion 27	Superseded

Pronouncement	*Appendix*
APB Opinion 28	A
APB Opinion 29	C
APB Opinion 30	E
APB Opinion 31	Superseded
FASB Statement No. 1	Superseded
FASB Statement No. 2	E
FASB Statement No. 3	A
FASB Statement No. 4	E
FASB Statement No. 5	E
FASB Statement No. 6	E
FASB Statement No. 7	D
FASB Statement Nos. 8 and 9	Superseded
FASB Statement No. 10	E
FASB Statement No. 11	E
FASB Statement No. 12	Superseded
FASB Statement No. 13	E
FASB Statement No. 14	Superseded
FASB Statement No. 15	E
FASB Statement No. 16	E
FASB Statement No. 17	Superseded
FASB Statement No. 18	Superseded
FASB Statement No. 19	D
FASB Statement No. 20	Superseded
FASB Statement No. 21	Superseded
FASB Statement No. 22	E
FASB Statement No. 23	E
FASB Statement No. 24	Superseded
FASB Statement No. 25	D
FASB Statement No. 26	Superseded
FASB Statement No. 27	E
FASB Statement No. 28	E
FASB Statement No. 29	E
FASB Statement No. 30	Superseded
FASB Statement Nos. 31 to 33	Superseded
FASB Statement No. 34	E
FASB Statement No. 35	D
FASB Statement No. 36	Superseded
FASB Statement No. 37	E
FASB Statement No. 38	E

Pronouncement	*Appendix*
FASB Statement Nos. 39 to 41	Superseded
FASB Statement No. 42	E
FASB Statement No. 43	E
FASB Statement No. 44	D
FASB Statement No. 45	D
FASB Statement No. 46	Superseded
FASB Statement No. 47	E
FASB Statement No. 48	E
FASB Statement No. 49	E
FASB Statement No. 50	D
FASB Statement No. 51	D
FASB Statement No. 52	E
FASB Statement No. 53	D
FASB Statement Nos. 54 to 56	Superseded
FASB Statement No. 57	E
FASB Statement No. 58	E
FASB Statement No. 59	Superseded
FASB Statement No. 60	D
FASB Statement No. 61	D
FASB Statement No. 62	E
FASB Statement No. 63	D
FASB Statement No. 64	E
FASB Statement No. 65	D
FASB Statement No. 66	E
FASB Statement No. 67	D
FASB Statement No. 68	E
FASB Statement No. 69	D
FASB Statement No. 70	Superseded
FASB Statement No. 71	D
FASB Statement No. 72	D
FASB Statement No. 73	D
FASB Statement No. 74	Superseded
FASB Statement No. 75	D
FASB Statement No. 76	Superseded
FASB Statement No. 77	E
FASB Statement No. 78	E
FASB Statement No. 79	E
FASB Statement No. 80	E

Pronouncement	*Appendix*
FASB Statement Nos. 81 to 83	Superseded
FASB Statement No. 84	B
FASB Statement No. 85	Superseded
FASB Statement No. 86	E
FASB Statement No. 87	E
FASB Statement No. 88	E
FASB Statement No. 89	A
FASB Statement No. 90	D
FASB Statement No. 91	D
FASB Statement No. 92	D
FASB Statement No. 93	E
FASB Statement No. 94	C
FASB Statement No. 95	E
FASB Statement No. 96	Superseded
FASB Statement No. 97	D
FASB Statement No. 98	E
FASB Statement No. 99	E
FASB Statement No. 100	Superseded
FASB Statement No. 101	D
FASB Statement No. 102	E
FASB Statement No. 103	Superseded
FASB Statement No. 104	E
FASB Statement No. 105	E
FASB Statement No. 106	E
FASB Statement No. 107	E
FASB Statement No. 108	Superseded
FASB Statement No. 109	E
FASB Statement No. 110	D
FASB Statement No. 111	E
FASB Statement No. 112	E
FASB Statement No. 113	D
FASB Statement No. 114	E
FASB Statement No. 115	A
FASB Statement No. 116	C
FASB Statement No. 117	C
FASB Statement No. 118	E
FASB Statement No. 119	E
FASB Statement No. 120	D

Pronouncement	*Appendix*
FASB Statement No. 121	E
FASB Statement No. 122	Superseded
FASB Statement No. 123	B
FASB Statement No. 124	C
FASB Statement No. 125	E
FASB Statement No. 126	E
FASB Statement No. 127	E
FASB Statement No. 128	A
FASB Statement No. 129	E
FASB Statement No. 130	A
FASB Statement No. 131	A
FASB Statement No. 132	E
FASB Interpretation No. 1	E
FASB Interpretation Nos. 2 and 3	Superseded
FASB Interpretation No. 4	E
FASB Interpretation No. 5	Superseded
FASB Interpretation No. 6	E
FASB Interpretation No. 7	D
FASB Interpretation No. 8	E
FASB Interpretation No. 9	D
FASB Interpretation Nos. 10 to 13	Superseded
FASB Interpretation No. 14	E
FASB Interpretation Nos. 15 to 17	Superseded
FASB Interpretation No. 18	A
FASB Interpretation No. 19	E
FASB Interpretation No. 20	E
FASB Interpretation No. 21	E
FASB Interpretation No. 22	Superseded
FASB Interpretation No. 23	E
FASB Interpretation No. 24	E
FASB Interpretation No. 25	Superseded
FASB Interpretation No. 26	E
FASB Interpretation No. 27	E
FASB Interpretation No. 28	B
FASB Interpretation No. 29	Superseded
FASB Interpretation No. 30	C
FASB Interpretation No. 31	Superseded
FASB Interpretation No. 32	Superseded
FASB Interpretation No. 33	D

Pronouncement	*Appendix*
FASB Interpretation No. 34	E
FASB Interpretation No. 35	A
FASB Interpretation No. 36	D
FASB Interpretation No. 37	E
FASB Interpretation No. 38	B
FASB Interpretation No. 39	E
FASB Interpretation No. 40	D
FASB Interpretation No. 41	E
FASB Interpretation No. 42	C

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Appendix G—The Hierarchy of GAAP

SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, establishes the hierarchy of GAAP.

For financial statements of entities other than governmental entities, the hierarchy is summarized as follows:

Category (a). Rule 203 literature consists of officially established accounting principles, which are FASB Statements and Interpretations, APB Opinions, and ARBs.

Category (b). This consists of FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides, and AICPA SOPs.

Category (c). This consists of AICPA AcSEC Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB EITF.

Category (d). This consists of AICPA accounting interpretations and implementation guides ("Qs and As") published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

If the accounting treatment of a transaction or event is not specified by Rule 203 literature, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from one or more sources in category (b), (c), or (d) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

Chapter 2
General Auditing Considerations

Scope of Services

2.01 The scope of services rendered by independent auditors depends on the kinds of reports to be issued as a result of the engagement. For each audit engagement, the auditor and the not-for-profit organization should establish an understanding, preferably in writing, of the scope of services to be performed and the reports to be issued.* The not-for-profit organization, after discussions with the auditor, should be sure that in addition to encompassing the financial statements, the scope of the engagement satisfies all relevant contractual, legal, and regulatory requirements. For example, the auditor may be engaged to issue reports that meet requirements found in *Government Auditing Standards* (often called the Yellow Book) issued by the Comptroller General of the United States.[1] Also, the auditor may be engaged to perform tests and issue reports required by the Single Audit Act Amendments of 1996 and United States Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*.[2] The auditor may also be engaged to prepare special reports on various financial data prepared by the organization, such as those related to bond indentures and other debt instruments and annual state information returns required by state attorneys general.

2.02 Paragraphs 21 through 23 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801), provide guidance on the auditor's responsibilities when he or she becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. SAS No. 74 provides that in that

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* Statement on Auditing Standards (SAS) No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), requires the auditor to establish an understanding with the client that includes the objectives of the engagement, the responsibilities of management and the auditor, and any limitations of the engagement. The Statement requires the auditor to document the understanding with the client in the workpapers, preferably through a written communication with the client. SAS No. 83 also identifies specific matters that ordinarily would be addressed in the understanding with the client, and other contractual matters an auditor might wish to include in the understanding.

[1] In practice, the standards included in *Government Auditing Standards* (1994 revision) are sometimes referred to as generally accepted government auditing standards (GAGAS). *Government Auditing Standards* includes standards for performance audits as well as standards for financial audits. The references to *Government Auditing Standards* in this Audit and Accounting Guide (Guide) pertain only to the standards for financial audits.

[2] OMB Circular A-133 includes requirements that the auditor perform tests and report on compliance with the cost principles and matching or cost-sharing requirements set forth in various other government regulations, such as OMB Circulars A-21, *Cost Principles for Colleges and Universities*; A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*; and A-122, *Cost Principles for Nonprofit Organizations*. OMB Circular A-133 was revised to incorporate state and local governments and to comply with other requirements of the Single Audit Act Amendments of 1996. The revised OMB Circular A-133, was issued in final form in June 1997, and is effective for audits of fiscal years beginning after June 30, 1996. The discussion of the requirements of OMB Circular A-133 in this Guide pertains to audits of fiscal years after that effective date.

situation "the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements." SAS No. 74 also notes that "the auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54 [*Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317)]."

Independence

2.03 Members of the AICPA who are engaged to audit the financial statements of not-for-profit organizations in accordance with generally accepted auditing standards (GAAS) are required to be independent. In making judgments about whether they are independent, members should be guided by Rule 101, *Independence*, of the AICPA Code of Professional Conduct, its Interpretations, and the Ethics Rulings under it. A number of Ethics Interpretations specifically address matters of independence as it relates to not-for-profit organizations.

Audit Planning

2.04 The first standard of fieldwork requires that the audit be adequately planned. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides broad guidance about audit risk and materiality at both the financial statement level and at the individual account-balance or class-of-transaction level when the auditor plans and performs an audit. Other authoritative pronouncements provide more specific guidance on planning considerations. This section discusses how that guidance should be applied in audits of not-for-profit organizations.

2.05 SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." The auditor plans the audit to obtain reasonable assurance of detecting misstatements that could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. SAS No. 47 notes that the auditor needs to consider audit risk at the individual account balance or class-of-transaction level to assist in determining the scope of auditing procedures for the balance or class and related financial statement assertions.

2.06 The auditor seeks to restrict audit risk at the individual account balance or class-of-transaction level in such a way as to enable the expression of an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. At the account balance or class-of-transaction level, audit risk consists of inherent risk, control risk, and detection risk, which are defined in SAS No. 47. This section describes inherent risk and control risk factors particularly relevant to the audit of a not-for-profit organization that the auditor should consider in planning the audit. (Later sections of this chapter as well as other chapters in the Guide discuss substantive tests unique to the industry that the auditor of a not-for-profit organization should consider in order to reduce detection risk.)

Industry Characteristics

2.07 The operations of not-for-profit organizations differ from those of for-profit entities in several significant ways, and those differences affect audit planning. Not-for-profit organizations use their resources to accomplish the purpose or mission for which they exist, not to generate net income. These resources often come from contributions, grants, or appropriations, some of which may be subject to limitations on how the resources may be used.[3] These limitations, which may be imposed by donor restrictions, by contractual terms, or by the organization's governing board, may require the auditor to test expenditures for compliance with relevant limitations.

2.08 Not-for-profit organizations are also required to comply with numerous other provisions of statutes, contractual agreements, terms of grants and trust agreements, and similar limitations. As discussed later in this chapter, the auditor is typically required to test for compliance with some of these provisions as well. Finally, though not-for-profit organizations are usually eligible for tax-exempt status under Section 501 of the Internal Revenue Code (IRC), the auditor should be aware that income from activities not related to a not-for-profit organization's exempt purpose may be subject to tax and that the organization may own or control for-profit subsidiaries. Taxes on unrelated business income and other tax matters that the auditor should consider in planning an audit of a not-for-profit organization are addressed in chapter 15, "Tax Considerations," of this Guide.

2.09 Not-for-profit organizations often have revenue and expenditure transactions that are unique to the industry, and these transactions have attendant implications for audit planning. For example, some not-for-profit organizations solicit contributions from various sources, some receive revenues from grants, and some organizations collect dues from members. Fund-raising may take place through telemarketing, direct mail solicitations, door-to-door solicitations, telethons, various kinds of special events, and other activities. Some organizations collect substantial amounts of contributions in the form of currency. Each of these sources of cash flows is associated with different kinds of risk. On the expenditure side, some not-for-profit organizations must also comply with restrictions imposed by resource providers. The revenue and expenditure transaction cycles of not-for-profit organizations may also include transactions that are similar to those entered into by for-profit enterprises—for example, buying and selling merchandise, purchasing investments, property and equipment, and other assets; providing services for fees, and earning income from investments. These cycles may include transactions that do not immediately result in revenues and expenses.

2.10 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, requires not-for-profit organizations to recognize agreements for future nonreciprocal transfers of cash, other assets, and services that are unconditional (that is, promises to give). Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses recognition and measurement principles for the assets and revenues related to such transactions. Applying those principles often involves the use of significant accounting estimates. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional*

[3] As used in this Guide, *limitation* refers broadly to any constraints imposed on the use of assets or net assets, *restriction* refers to donor-imposed limitations, and *designation* refers to governing-board-imposed limitations.

Standards, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support those estimates.

2.11 Not-for-profit organizations also have unique reporting requirements under generally accepted accounting principles (GAAP). For example, they must report their expenses by function, such as major classes of program services and supporting activities, in conformity with FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. They are also subject to specific disclosure requirements under FASB Statement No. 116, such as disclosures about promises to give, contributed services, and collections.

2.12 Each of these kinds of transactions and reporting requirements creates audit risk that the auditor should address. Each also requires the auditor to consider management's implicit financial statement assertions and to formulate specific audit objectives based on those assertions. Not-for-profit organizations usually have controls designed to achieve control objectives related to these transactions.

2.13 Many not-for-profit organizations face financial and operating pressures that are similar to those faced by for-profit enterprises. Not-for-profit organizations may also face pressures that are unique to institutions that seek revenues in the form of contributions and grants, transactions that often depend on the state of the economy. These pressures generate operating, financial, and accounting responses by management, and such responses may increase both inherent risk and control risk, which the auditor should recognize and respond to in planning the audit. The following are examples:

- Certain donors may tie contribution allocation formulas to the organization's actual or budgeted revenues, leading management to attempt to manage revenues to achieve the largest allocation possible.
- A sluggish economy may reduce contributions and the collection of promises to give that were made in prior years. The reduced receipts may lead the organization to pursue a more aggressive investment strategy involving complex financial instruments. Accounting for these instruments may increase the risk of financial statement misstatements; the auditor should understand the substance of these instruments and determine that they are reported in conformity with GAAP.
- Adverse demographics may lead an organization that charges fees for its services to pursue a more aggressive marketing strategy in its quest for constituents; this could decrease the collectibility of its receivables.
- Shortfalls in unrestricted contributions may induce an organization to use restricted contributions for purposes that violate donor restrictions.
- Acceptance by an organization of federal research and other grants carries with it an obligation to comply with federal regulations when the organization administers those grants. Such regulations include those governing overhead and other costs charged to these grants. The terms of the grants may induce organizations to charge unallowable costs to the grants, possibly resulting in liabilities for fines and repayment of any unallowable costs.
- An attempt to appear as efficient as possible may increase the likelihood of misstatement of the allocation of costs between program services and supporting activities. (Because some financial statement users view program expenses more favorably than supporting services, some not-for-profit organizations have incentive to report costs as program rather than supporting services.)

Organization Characteristics

2.14 Effective audit planning requires (*a*) an understanding of the industry in which a particular not-for-profit organization operates and (*b*) knowledge of the specific entity being audited and its uniqueness in relation to the industry. That knowledge should include understanding the way the entity is organized and its operating characteristics (including the level of involvement and oversight exercised by the governing board), sources of revenues, principal expenditures, accounting policies, methods used to process accounting information, and related controls. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides further guidance on matters that the auditor should consider in planning the engagement.

Internal Control Considerations

2.15 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the objectives and components of an entity's internal control and explains how an auditor should consider internal control in planning and performing an audit. SAS No. 55, as amended, requires that to plan the audit, the auditor should obtain an understanding of the entity's internal control sufficient to plan the audit.

2.16 SAS No. 78 defines internal control as "a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations."[4] The five components of an entity's internal control are the following:

a. The control environment

b. Risk assessment

c. Control activities

d. Information and communication

e. Monitoring

SAS No. 55, as amended, discusses each of these five components.

2.17 The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether the controls have been placed in operation. The auditor's primary consideration, however, is whether a specific control affects financial statement assertions rather than its classification into any particular component.

2.18 The auditor should assess control risk for the assertions embodied in the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the organization's internal control) if the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or if evaluating their ef-

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[4] Paragraph 9 of SAS No. 78 provides that "although an entity's internal control addresses objectives in each of the categories referred to in paragraph 6, not all of these objectives and related controls are relevant to an audit of the entity's financial statements."

fectiveness would be inefficient. Alternatively, the auditor may obtain evidence from tests of controls about the effectiveness of both the design and operation of a control that would support a lower assessed level of control risk. Tests of controls may be performed concurrently with obtaining the understanding (either as a result of audit planning or not), or they may be performed after obtaining an understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests to be performed.

2.19 Certain characteristics of internal control, particularly in the control environment, may be unique to not-for-profit organizations. SAS No. 78 states that auditors should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment considering both the substance of controls and their collective effect. The following are examples of characteristics of a not-for-profit organization's control environment that the auditor should consider in obtaining an understanding of that environment:

- The role of management and the governing board
- The frequency of governing board meetings
- The qualifications of management and governing board members
- The governing board members' involvement in the organization's operations
- The organizational structure

2.20 The other four components of internal control of not-for-profit organizations may also include characteristics that would not ordinarily exist in for-profit entities. The auditor should obtain sufficient knowledge of the other four components to understand how—

- Restricted contributions are identified, evaluated, and accepted.
- Promises to give are valued and recorded.
- Contributed goods, services, utilities, facilities, and the use of long-lived assets are valued and recorded.
- Compliance with donor restrictions and board designations is monitored.
- Reporting requirements imposed by donors, contractors, and regulators are met.
- Conformity with accounting presentation and disclosure principles, including those related to functional and natural expense reporting and allocation of joint costs, is achieved.
- New programs are identified and accounted for.

Analytical Procedures

2.21 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires that analytical procedures be applied "to assist the auditor in planning the nature, timing, and extent of other auditing procedures." Analytical procedures are required in the planning and overall review phases of the audit. Analytical procedures applied at the planning stage may be similar to those applied as substantive tests and in the final review stage of the audit, but they generally use more highly aggregated, unaudited data whose reliability is unknown to the auditor because control risk associated with the data has not always been assessed at the planning stage.

2.22 SAS No. 56 provides examples of sources of information that can be used to develop the necessary expectations for applying analytical procedures. The sources of information that may be unique to not-for-profit organizations are (1) "information regarding the industry in which the client operates" and (2) "relationships of financial information with relevant nonfinancial information." The first of these requires industry-wide data to be used for comparisons (such as data on endowment return, contributions, or program, fund-raising, and management and general costs that can be obtained from industry trade and professional associations). The second requires the auditor to formulate relevant relationships that are usually unique to a particular type of not-for-profit organization, such as the relationship that might be expected to exist at a college or university between the number of students registered at standard tuition rates and tuition revenues, the relationship between the number of members in an organization and its dues revenue, and the relationship between stagehand costs and the number of theatrical, dance, orchestral, or similar performances. These analytical procedures may be applied in all phases of the audit.

Related-Party Transactions

2.23 Obtaining knowledge of the client's organization and operations should include performing the procedures in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334), to determine the existence of related-party relationships and transactions with such parties and to examine those transactions. The auditor of a not-for-profit organization should be aware that the definition of related parties in FASB Statement No. 57, *Related Party Disclosures*, includes an organization's management and members of management's immediate family, as well as affiliated entities. Accordingly, transactions with brother-sister organizations and certain national and local affiliates as well as entities whose officers or directors are members of the not-for-profit organization's governing board may have to be disclosed under FASB Statement No. 57.

2.24 SAS No. 45 provides guidance on, among other matters, procedures that the auditor should consider to identify related party relationships and transactions and to obtain satisfaction about the related financial statement reporting and disclosure. Obtaining that information will be enhanced if the organization has a policy that requires an annual written disclosure by governing board members of the details of their transactions and other business involvements with the organization, as well as disclosure of their other board memberships. Some states require that these kinds of disclosures be made on the annual reporting form filed by the organization.

2.25 Some states have exhibited a heightened concern about whether the governing board members of not-for-profit organizations are meeting their stewardship responsibilities, particularly if there are potential conflicts between the governing board members' financial interests and their duties as governing board members. Responses by an organization to that concern might include increased sensitivity when it enters into business relationships with governing board members and might include developing appropriate controls for addressing potential conflicts of interests that could arise in related-party transactions and for ensuring that such transactions are disclosed to and approved by the governing board.

Errors and Fraud

2.26 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[5] SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides guidance on the auditor's consideration of the risk that the financial statements are materially misstated by error or fraud. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement, whether caused by error or fraud, and provides guidance on what should be done to meet those responsibilities. The Statement describes fraud and its characteristics; requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors to be considered in the auditor's assessment; provides guidance on how the auditor responds to the results of the assessment; provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud; describes related documentation requirements; and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others. As described in paragraph 16 of SAS No. 82, risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped into three categories: management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability.

Illegal Acts

2.27 SAS No. 54 prescribes the nature and extent of the consideration the auditor should give to the possibility of illegal acts by a client. It also provides guidance on the auditor's responsibilities when a possible illegal act is detected, including the responsibility to be assured that the audit committee or its equivalent is adequately informed about illegal acts that come to the auditor's attention.

2.28 SAS No. 54 notes that illegal acts vary considerably in their relation to the financial statements. Some laws and regulations—such as sections of the tax law that affect tax provisions and accruals because of unrelated business income, and government regulations that affect the amount of revenue accrued under government contracts—may have a direct and material effect on the determination of financial statement amounts. The auditor's responsibility to detect misstatements resulting from direct-effect illegal acts is the same as for errors and fraud (see footnote 5). Accordingly, management should identify federal, state, and local laws and regulations that may have a direct and material effect on the determination of financial statement amounts. The auditor should assess the appropriateness of that identification and obtain an understanding of the possible effects of those laws and regulations on the financial statements.

2.29 Not-for-profit organizations frequently receive financial assistance—such as grants, loans, loan guarantees, and interest-rate subsidies—from federal, state, and local governmental entities. By accepting such assistance, organizations often become subject to laws and regulations that

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[5] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud.

may have a direct and material effect on the determination of amounts in their financial statements. Such laws and regulations may specifically address (*a*) the types of goods or services that organizations may purchase with the assistance, (*b*) the eligibility of those to whom organizations may provide benefits, (*c*) amounts organizations must contribute from their own resources toward projects for which financial assistance is provided, and (*d*) principles and standards for determining the direct and indirect costs that are allowable as charges to governmental financial assistance programs.

2.30 Other laws and regulations relate more to an organization's operating aspects than to its financial and accounting aspects, and violations of these laws and regulations have only an indirect effect on the financial statements. (The indirect effect is usually limited to the need to disclose a contingent liability under FASB Statement No. 5, *Accounting for Contingencies*, because of the allegation or determination of illegality and the possibility of fines, penalties, or damages.) Such laws and regulations may concern securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, or antitrust violations. An example particular to the not-for-profit environment might be the requirement that an organization inform contributors of the portion of their contributions that is tax deductible; the failure to do so could subject the organization to financial penalties. SAS No. 54 does not require the auditor to design auditing procedures to detect illegal acts that do not have a direct and material effect on the financial statements; SAS No. 54 refers to these acts simply as "illegal acts." SAS No. 54 specifies the auditor's responsibilities when he or she becomes aware of information concerning illegal acts.

Compliance Auditing Under *Government Auditing Standards*

2.31 Not-for-profit organizations that receive government financial assistance may be required to have audits in accordance with government auditing standards, as specified in the Yellow Book.[6] Government auditing standards pertain to auditors' professional qualifications, the quality of the work performed, and the characteristics of the reports issued. In performing an audit in accordance with the Yellow Book, the auditor assumes reporting responsibilities beyond those required by GAAS. The auditor must report on compliance with laws and regulations, violations of which may affect financial statement amounts, and on the organization's internal control over financial reporting.

Single Audits and Related Considerations

2.32 OMB Circular A-133 also prescribes audit requirements for not-for-profit organizations receiving federal awards.[7] The audit requirements of Circular A-133 vary with the amount of federal awards an organization receives.[8]

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[6] Though government auditing standards primarily apply to federal financial assistance, some states have adopted government auditing standards.

[7] A single audit is an audit of an entity's financial statements and of compliance with federal regulations relating to federal financial assistance, such as the audits required by Single Audit Act of 1984, as amended by the Single Audit Act Amendments of 1996, and OMB Circular A-133. Program-specific audits may be conducted in accordance with specific government audit guides, such as the U.S. Department of Education's Audit Guide, *Compliance Audit (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions*.

[8] OMB Circular A-133 requires not-for-profit organizations that expend $300,000 or more in federal awards in a year to have an audit in accordance with the Circular. (Generally, organizations that expend $300,000 or more, but under only one program, have the option of having a program-specific audit or a single audit in accordance with OMB Circular A-133.) Organizations that expend less than $300,000 must maintain records and make them available for review, if requested, but they are exempt from OMB Circular A-133 audit requirements.

2.33 For audits performed in accordance with OMB Circular A-133, the auditor has responsibilities specified in the circular that go beyond GAAS. In such audits, the auditor must perform additional procedures to test and report on compliance with specified laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on major federal award programs (as defined in the circular). Other requirements of OMB Circular A-133 include reports on the financial statements, on the supplementary schedule of expenditures of federal awards, and on internal control relevant to major federal award programs.

2.34 SAS No. 74 and Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*,[9] provide guidance on testing and reporting on compliance with laws and regulations in engagements performed under GAAS, the Yellow Book, and OMB Circular A-133. They provide auditors of not-for-profit organizations with a basic understanding of the work they should do and the reports they should issue under the Yellow Book and OMB Circular A-133. (Auditors may be asked to report on either (*a*) an organization's compliance with specified requirements of state and local laws, regulations, contracts, and grants or (*b*) the effectiveness of the organization's internal control over compliance with specified requirements. In such circumstances, auditors should refer to Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500), which provides guidance for engagements to report on management's written assertion about such matters. SSAE No. 3, as amended by SAS No. 74, also applies to engagements for which the terms specify an attestation report.)

Processing of Transactions by Service Organizations

2.35 In addition to transactions, such as discretionary investment management services and payroll, for which for-profit organizations might use service organizations, not-for-profit organizations may also use such organizations to process transactions, such as student financial aid payments and receipt of contributions, that are unique to that industry. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors the auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. The auditor should also consider the not-for-profit organization's compliance with laws, regulations, and contractual agreements that may apply when service organizations are used to process transactions.

Using the Work of a Specialist

2.36 Organization management or the auditor may engage a specialist to provide special skill or knowledge about complex or subjective matters that are potentially material to the financial statements. Auditors of not-for-profit organizations, for example, may need to use the work of a specialist with respect to the valuation of contributed assets, particularly contributed collection items that the organization capitalizes. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to an auditor who uses the work of a specialist.

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[9] SOP 98-3 is included as appendix D of this Guide. SOP 98-3 provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133 (June 1997 revision).

Planning Stage Materiality

2.37 SAS No. 47 states that "the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements." Expenditures of not-for-profit organizations are often tightly controlled and based on the concept of a balanced budget, with relatively small or zero *operating* margins. As a result, the auditor may consider materiality for planning purposes from various perspectives, such as total net assets, various net asset classes, changes in net assets, changes in net asset classes, total revenues, revenues of each net asset class, total expenses, or other measures—such as total unrestricted contributions, total program expenses, the ratio of program expenses to total expenses, and the ratio of fund-raising expenses to contributions.

2.38 In an audit of compliance with requirements governing major federal award programs in accordance with OMB Circular A-133, materiality should be considered in terms of each major program.[10] For example, materiality could be considered in relation to the separate assets, revenues, or expenditures of each program that is being reported on.

Audit Objectives and Audit Procedures

2.39 The auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning management's assertions embodied in the financial statements. Those assertions may be either explicit or implicit and can be classified according to the following broad categories: existence and occurrence, completeness, rights and obligations, valuation and allocation, and presentation and disclosure. The assertions also serve as broad audit objectives.

2.40 The purpose of the specific audit objectives, examples of controls, and examples of auditing procedures in the tables presented in the auditing sections of several of the following chapters is to assist the auditor in understanding internal control, assessing control risk, and performing auditing procedures. The tables include only those matters that are unique to not-for-profit organizations. Accordingly, they should not be considered a complete listing of all of the audit objectives, controls, and auditing procedures that the auditor should consider when auditing a not-for-profit organization. In addition, the absence of examples of selected controls related to a particular financial statement assertion is intended to indicate that the assertion does not ordinarily lend itself to specific controls that would provide reasonable assurance that the related audit objective has been achieved.

2.41 There is not necessarily a one-to-one relationship between audit objectives and auditing procedures. Some procedures may relate to more than one objective. On the other hand, a combination of procedures may be necessary to achieve a single objective. The tables are not intended to be all-inclusive or to suggest that specific audit objectives, controls, and auditing procedures should be applied. Some of the audit objectives may not be relevant to a particular organization because of the nature of its operations or the absence of certain types of transactions. The absence of one or more of the illustrative controls would not necessarily indicate a deficiency in internal control.

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[10] [Footnote deleted.]

2.42 Many of the illustrative controls are premised on the existence of certain essential characteristics of internal control: for example, authorization of transactions, segregation of duties, documentation, supervision and review, and timeliness of controls. To avoid repetition, these characteristics have not been explicitly incorporated in the tables.

Completing the Audit

2.43 The procedures involved in completing the audit include the following:

- Performing analytical procedures in the overall review stage
- Summarizing and evaluating possible audit adjustments
- Obtaining legal letters
- Reviewing for subsequent events
- Obtaining written management representations
- Evaluating whether there is a substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time
- Preparing the auditor's reports
- Communicating reportable conditions, errors and irregularities, illegal acts, and matters that may be required by SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)

This section of the Guide discusses aspects of these procedures that are unique to not-for-profit organizations.

Management Representations

2.44 SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires that the independent accountant obtain written representations from management as a part of an audit of financial statements performed in accordance with GAAS and provides guidance concerning the representations to be obtained. Written representations from management should be obtained for all financial statements and periods covered by the accountant's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Paragraph 6 of SAS No. 85 lists matters ordinarily included in management's representation letter. Additional representations specific to not-for-profit organizations that may be obtained include the following:

- Compliance with contractual agreements, grants, and donor restrictions
- Maintenance of an appropriate composition of assets in amounts needed to comply with all donor restrictions
- Taxation and tax-exempt status
- Reasonableness of bases for allocation of functional expenses
- Inclusion in the financial statements of all assets and liabilities under the entity's control
- Adequacy of internal control over the receipt and recording of contributions
- Propriety of reclassifications between net asset classes
- The governing board's interpretation concerning whether laws place restrictions on net appreciation of donor-restricted endowments.

2.45 Paragraph 7 of SAS No. 74 notes that an auditor who has been engaged to audit an organization that receives government funds that make it subject to government-imposed compliance testing and reporting requirements of the Yellow Book should consider obtaining written representations from management concerning the completeness of management's identification of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

2.46 SOP 98-3 lists suggested representations that the auditor should consider obtaining in a single audit required by OMB Circular A-133.

Going-Concern Considerations

2.47 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to the auditor in meeting the responsibility to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. SAS No. 59 gives examples of conditions and events that might indicate that there could be substantial doubt about the entity's continued existence. Additional examples of such conditions and events that are particularly applicable to not-for-profit organizations include the following:

- Insufficient unrestricted revenues to provide supporting services to activities funded by restricted contributions
- A high ratio of fund-raising expenses to contributions received or a low ratio of program expenses to total expenses
- Insufficient resources to meet donor's restrictions (This may result from the use of restricted net assets for purposes that do not satisfy the donor's restrictions, sometimes referred to as interfund borrowing.)
- Activities that could jeopardize the organization's tax-exempt status and thus endanger current contribution levels
- Concerns expressed by governmental authorities regarding alleged violations of state laws governing an organization's maintenance or preservation of certain assets, such as collection items
- A loss of key governing board members or volunteers
- External events that could affect donors' motivations to continue to contribute
- Decreases in revenues contributed by repeat donors
- A loss of major funding sources

Chapter 3

Basic Financial Statements

Introduction

3.01 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, establishes standards for general-purpose external financial statements prepared by not-for-profit organizations. It specifies that a complete set of financial statements should include a statement of financial position, a statement of activities, a statement of cash flows,[1] accompanying notes to the financial statements, and for voluntary health and welfare organizations, a statement of functional expenses.[2] Appendix C of FASB Statement No. 117 includes illustrations of those financial statements.

3.02 A set of financial statements of a not-for-profit organization should include information required by generally accepted accounting principles (GAAP), except for principles included in authoritative pronouncements that specifically exempt not-for-profit organizations,[3] including information required by applicable specialized accounting and reporting principles and practices, such as those specified in this Guide. The requirements of FASB Statement No. 117 are generally no more stringent than the requirements for for-profit organizations; accordingly, although FASB Statement No. 117 does not specify the degree of aggregation and the order of presentation in financial statements of not-for-profit organizations, they should be similar to what is required or permitted for for-profit organizations. Appendix C to FASB Statement No. 117 includes financial statements that illustrate some of the ways in which the requirements of the Statement can be met.

Statement of Financial Position

3.03 A statement of financial position should focus on the organization as a whole and should report the amounts of its assets, liabilities, and net assets. Assets and liabilities should be aggregated into reasonably homogeneous groups. Assets need not be disaggregated on the basis of the presence of donor-

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[1] As discussed in chapter 5, "Contributions Received and Agency Transactions," of this Audit and Accounting Guide (Guide), some not-for-profit organizations receive resources in agency transactions. For some of those organizations, receiving resources as agents may be a primary component of their mission. Those organizations should consider presenting the statement of cash flows as the first financial statement presented in their set of financial statements, in order to emphasize the importance of the information presented in that statement.

[2] The terms *statement of financial position*, *statement of activities*, and *statement of functional expenses* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. For example, a statement reporting financial position could be called a *balance sheet* as well as a *statement of financial position*. Current practice and the statement's purpose suggest, however, that a statement of cash flows only be titled "Statement of Cash Flows."

[3] Chapter 1, "Introduction," of this Guide, incorporates Statement of Position (SOP) 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which is superseded by this Guide for organizations that are included in the scope of this Guide.

imposed restrictions on their use; for example, cash available for unrestricted current use need not be reported separately from cash received with donor-imposed restrictions that is also available for current use.[4] However, cash or other assets either (*a*) designated for long-term purposes or (*b*) received with donor-imposed restrictions that limit their use to long-term purposes should not be aggregated on a statement of financial position with cash or other assets that is available for current use. For example, cash that has been received with donor-imposed restrictions limiting its use to the acquisition of long-lived assets should be reported under a separate caption, such as "cash restricted to investment in property and equipment," and displayed near the section of the statement where property and equipment is displayed. The kind of asset should be described in the notes to the financial statements if its nature is not clear from the description on the face of the statement of financial position.

3.04 Paragraph 12 of FASB Statement No. 117 requires that one or more of the following techniques be used to provide information about the organization's liquidity:

a. Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash

b. Classifying assets and liabilities as current and noncurrent, as defined by Accounting Research Bulletin No. 43, Chapter 3A, "Working Capital—Current Assets and Current Liabilities"

c. Disclosing in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets

Information about the liquidity or maturity of assets and liabilities should be disclosed in a separate note to the financial statements if that information is not apparent from the face of the statements or the other notes.

3.05 A statement of financial position should report amounts for each of three classes of net assets (permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets) as well as total net assets. The three net asset classes should be based solely on the existence or absence of donor-imposed restrictions. (As discussed in paragraph 3.07, board-designated limitations on the use of unrestricted net assets are permitted to be disclosed.)

3.06 Permanently restricted net assets result from contributions whose use is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by the organization's actions. Temporarily restricted net assets result from contributions whose use is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to these stipulations. Net assets may be temporarily restricted for various purposes, such as use in future periods or use for specified purposes.

3.07 In the absence of donor-imposed restrictions, net assets should be classified as unrestricted. Paragraph 16 of FASB Statement No. 117 permits organizations to disclose self-imposed limitations on the use of unrestricted net

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[4] Assets other than cash may also be restricted by donors. For example, land could be restricted to use as a public park. Generally, however, restrictions apply to net assets, not to specific assets.

assets (such as board-designated endowments) in the notes to the financial statements or on their face, provided that total unrestricted net assets are displayed. Contractual limitations on the use of particular assets (such as cash held on deposit as a compensating balance) should be disclosed either on the face of the statement of financial position or in the notes to the financial statements.

Statement of Activities

3.08 A statement of activities should focus on the organization as a whole and should report the amount of the change in net assets for the period, using a descriptive term such as *change in net assets* or *change in equity*. The statement should report the amounts of the changes in permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and total net assets. Revenues, expenses, gains, and losses should be classified by net asset class.[5] Events that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items. Classification of revenues, expenses, gains, and losses and reclassifications are discussed in greater detail in subsequent chapters of this Guide.

3.09 Paragraph 7 of FASB Statement No. 117 requires the display of an appropriately labeled subtotal within a statement of activities for the change in each class of net assets before the effects of extraordinary items, discontinued operations, or accounting changes. (Paragraph 7 of FASB Statement No. 117 also notes that not-for-profit organizations should apply the appropriate disclosure and display requirements for, among other things, unusual and infrequently occurring events.)

3.10 The determination of the net asset class in which revenues, gains, and losses should be reported should be based solely on the presence or kind of donor-imposed restrictions. In the absence of such restrictions, revenues should be reported as increases in unrestricted net assets. All expenses should be reported as decreases in unrestricted net assets. Gains should be reported as increases, and losses as decreases, in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law. Expirations of donor-imposed restrictions that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items.

3.11 FASB Statement No. 117 does not specify the way that revenues, expenses, gains, losses, and reclassifications should be sequenced. Paragraph 158 of FASB Statement No. 117 suggests several ways that items constituting those elements could be sequenced: (*a*) revenues and gains, reclassifications, expenses, and losses; (*b*) revenues, expenses, gains, losses, and reclassifications; and (*c*) certain revenues, less directly related expenses, followed by a subtotal, then other revenues, other expenses, gains and losses, and reclassifications. Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses alternative ways of reporting costs related to sales of goods and services and the direct costs of special events.

3.12 An organization may, if it wishes, incorporate additional classifications within the statement of activities. For example, it may classify revenues and expenses within a class or classes of net assets as operating and nonoperating, expendable and nonexpendable, recurring and nonrecurring, or in other ways, such as by business segments.

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[5] Paragraph 20 of FASB Statement No. 117 requires expenses to be reported as decreases in unrestricted net assets.

3.13 Accordingly, an intermediate measure of operations, such as an excess or deficit of operating revenues over expenses, may be reported in a statement of activities, as long as the use of the term *operations* is clear either from the details provided on the face of the statement or from a description contained in a note to the financial statements. If an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in total unrestricted net assets for the period.

Reporting Expenses

3.14 To help users assess an organization's service efforts, including the costs of its services and how it uses resources, a statement of activities or the notes to the financial statements should report expenses by their functional classification, such as major programs and supporting activities. Voluntary health and welfare organizations[6] are required to report that information, together with information about expenses by their natural classification in a matrix format in a separate financial statement. A natural classification of expenses would include expense categories such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees. To the extent that those expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), they should be reported by their natural classification if information about expenses by their natural classification is presented on the separate financial statement (matrix) containing natural classifications. For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of activities should be included with other salaries, wages, and fringe benefits on the matrix containing natural classifications. FASB Statement No. 117 encourages, but does not require, other not-for-profit organizations to provide information about expenses by their natural expense classification.

Statement of Cash Flows

3.15 FASB Statement No. 117 amends FASB Statement No. 95, *Statement of Cash Flows*, by extending its provisions to not-for-profit organizations. A statement of cash flows provides relevant information about an organization's cash receipts and cash payments during a period; the statement classifies those receipts and payments as resulting from investing, financing, or operating activities. Separate disclosure of noncash investing and financing activities (for example, receiving contributions of buildings, securities, or recognized collection items) is also required.

3.16 Operating activities are defined in FASB Statement No. 95 as including "all transactions and other events that are not defined as investing or financing activities" (paragraph 21). Cash flows from operating activities are not limited to the cash effects of transactions and other events that are reported on an organization's statement of activities and would include, if applicable, agency transactions.

3.17 FASB Statement No. 95 permits entities to use either the direct or the indirect method of reporting cash flows from operating activities. The direct

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[6] *Voluntary health and welfare organizations* are defined in appendix D of FASB Statement No. 117. That definition includes a provision that "as a group, voluntary health and welfare organizations include those not-for-profit organizations that derive their revenue primarily from voluntary contributions from the general public..." For purposes of this Guide, the *general public* excludes governmental entities.

method reports major classes of gross cash receipts and gross cash payments from operating activities to arrive at a subtotal of net cash provided by or used in operating activities (net cash flow from operating activities). The direct method also requires a reconciliation of the change in (total) net assets to the net cash flow from operating activities in a separate schedule. The indirect method starts with the change in (total) net assets for the period and reconciles that amount to a subtotal of net cash flow from operating activities.

3.18 FASB Statement No. 117 expands the description of financing activities in FASB Statement No. 95 to encompass receipts of resources that are donor-restricted for long-term purposes. As discussed in paragraph 3.03 of this Guide, cash that is received with donor-imposed restrictions limiting its use to long-term purposes should not be aggregated on a statement of financial position with cash that is available for current use. In order for the statement of cash flows to reconcile beginning and ending cash and cash equivalents, and to report in conformity with FASB Statement No. 95, as revised by FASB Statement No. 117, the receipt of a cash contribution that is restricted for the purchase of equipment should be reported as a cash flow from financing activities (using a caption such as "contributions restricted for purchasing equipment"), and it should be simultaneously reported as a cash outflow from investing activities (using a caption such as "purchase of assets restricted to investment in property and equipment" or, if the equipment was purchased in the same period, "purchase of equipment").[7] An adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as "cash or cash equivalents" on the statement of financial position. If the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the equipment and the purchase of the equipment should be reported as cash flows from investing activities.

3.19 Not all assets of not-for-profit organizations that meet the definition of *cash equivalents* in FASB Statement No. 95 are cash equivalents for purposes of preparing statements of financial position and cash flows. As noted in paragraph 3.03, restrictions can prevent them from being included as cash equivalents even if they otherwise qualify. For example, short-term highly liquid investments are not cash equivalents if they are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment. Further, paragraph 10 of FASB Statement No. 95 states that an organization can, by policy, exclude from cash equivalents items that meet the definition of "cash equivalents." For example, an organization may hold a portion of its endowment portfolio in cash or other instruments with maturities of less than three months and exclude the cash and other instruments from "cash and cash equivalents." Similarly, cash and investments of endowment funds held temporarily until suitable long-term investments are identified may be excluded from cash equivalents. Paragraph 10 of FASB Statement No. 95 requires organizations to disclose their policy for determining which items are treated as cash equivalents.

Comparative Financial Information

3.20 Not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. Such

[7] Paragraphs 3.03 and 3.19 of this Guide discuss the classification on a statement of financial position of cash received with donor-imposed restrictions limiting its use to long-term purposes.

summarized information may not include sufficient detail to constitute a presentation in conformity with GAAP. If the prior year's financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this Guide (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior-year information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements.[8, 9] The use of appropriate titles includes a phrase such as "with summarized financial information for the year ended June 30, 19PY," following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior-year summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title.

3.21 An example of a note to the financial statements[10] that describes the nature of the prior-period(s) information would be as follows:

> The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the organization's financial statements for the year ended June 30, 19PY, from which the summarized information was derived.

Reporting of Related Entities

3.22 In September 1994, the AICPA issued SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which is included as appendix B [paragraph 8.29] to chapter 8, "Investments," of this Guide.[11] SOP 94-3 amends and makes uniform the previously existing guidance concerning reporting related entities. The SOP is effective for financial statements issued for fiscal years beginning after December 31, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 31, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117 prior to its effective date, earlier application of the SOP is encouraged. Comparative financial statements for earlier periods included with those for which the SOP is adopted should be restated.

3.23 Some of the conclusions in SOP 94-3 depend on whether the reporting not-for-profit organization has an economic interest in other organizations. The Glossary of SOP 94-3 includes examples of economic interests. In addition to the examples included in the Glossary, the following is an example of an economic interest:

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[8] Chapter 14, "Reports of Independent Auditors," of this Guide, discusses auditors' reports on comparative financial information.

[9] Because the note discusses information that does not pertain to the current-period financial statements, the note is not considered to be part of the current-period financial statements.

[10] See footnote 9.

[11] The FASB currently has a project on its agenda on consolidations and related matters and has released an October 16, 1995, exposure draft, *Consolidated Financial Statements: Policy and Procedures*, in connection with that project. The conclusions in SOP 94-3 may be modified by a pronouncement resulting from that project.

The reporting entity has a right to or a responsibility for the operating results of another entity. Or upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity.

Financial Statement Disclosures Not Considered Elsewhere

3.24 Financial statement disclosures are generally discussed in this Guide in connection with the specific financial statement items to which they pertain. This section discusses disclosures that are unique to not-for-profit organizations and that are not discussed elsewhere in this Guide.

Noncompliance With Donor-Imposed Restrictions[12]

3.25 A not-for-profit organization may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). Such noncompliance could result in a material contingent liability, result in a material loss of future revenue, or cause the organization to be unable to continue as a going concern.

3.26 FASB Statement No. 5, *Accounting for Contingencies*, provides guidance for accruing and disclosing contingent liabilities. Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), addresses disclosure of illegal acts that could lead to a material loss of revenue. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), contains broad guidance on disclosures when there is a substantial doubt about an entity's ability to continue as a going concern.

3.27 Noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.[13] If the noncompliance results from an organization's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances should be disclosed.

Risks and Uncertainties

3.28 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires entities to include in their financial statements information about the following:

- The nature of their operations
- Use of estimates in the preparation of financial statements

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[12] As discussed in chapter 11, "Net Assets," of this Guide, and throughout other sections of this Guide, not-for-profit organizations should report amounts for each of three classes of net assets. Noncompliance with donor-imposed restrictions may result in net assets being reported other than in accordance with donor-imposed restrictions. For example, net assets would be reported other than in accordance with donor-imposed restrictions if restricted net assets were reported as unrestricted net assets. If net assets are reported other than in accordance with donor-imposed restrictions, the financial statements are not presented in conformity with GAAP.

[13] As discussed in paragraph 10.11, noncompliance with donor-imposed restrictions may require accrual of a liability in conformity with FASB Statement No. 5.

In addition, if specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about the following:

- Certain significant estimates
- Current vulnerability due to certain concentrations

The SOP includes examples of disclosures that may be pertinent for not-for-profit organizations. The provisions of the SOP are effective for financial statements issued for fiscal years ending after December 15, 1995.

Chapter 4
Cash and Cash Equivalents

Introduction

4.01 Like for-profit enterprises, not-for-profit organizations hold cash balances to meet payments arising in the ordinary course of operations and payments for unanticipated contingencies. These balances may be held as cash or cash equivalents.

4.02 Cash includes currency on hand and deposits held by financial institutions that can be added to or withdrawn without limitation, such as demand deposits. Paragraph 8 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*, defines *cash equivalents* as "short-term, highly liquid investments that are both (*a*) readily convertible to known amounts of cash [and] (*b*) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates."[1] Not-for-profit organizations may invest excess cash in cash equivalents (such as treasury bills, commercial paper, and money-market mutual funds) to earn greater returns.

Financial Statement Presentation

4.03 A statement of financial position should include a separate line item, "Cash" or "Cash and Cash Equivalents." As noted in paragraph 3.03, cash and cash equivalents received with donor-imposed stipulations restricting the use of the cash contributed to long-term purposes and cash set aside for long-term purposes should not be classified on a statement of financial position with assets that are available for current use.[2]

4.04 Some limitations may exist on an organization's ability to withdraw or use cash and cash equivalents. These limitations may be imposed by (*a*) creditors and other outside parties (such as limitations on cash held by financial institutions to meet compensating balance requirements, cash and cash equivalents held as collateral on debt obligations, cash received as collateral on loaned securities, and cash held for students, clients, and others under agency agreements); (*b*) donors, who place permanent or temporary restrictions on their cash contributions (such as restricting the contributions to in-

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[1] Paragraph 8 of FASB Statement No. 95 indicates that, "...generally, only investments with original maturities [footnote reference omitted] of three months or less qualify under that definition."

[2] As noted in paragraph 3.04 of this Audit and Accounting Guide (Guide), paragraph 12 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires not-for-profit organizations to do one or more of the following: (*a*) sequence assets based on their nearness to cash, (*b*) classify assets as current and noncurrent, or (c) include relevant information about assets' liquidity, including restrictions on the use of particular assets, in notes to the financial statements. Paragraph 156 of Statement No. 117 illustrates this requirement: cash and cash equivalents restricted by donors to investment in fixed assets are not included as "cash or cash equivalents" but as "assets restricted to investment in land, buildings, and equipment"; cash and cash equivalents contributed by donors with stipulations that the contributed assets be invested permanently are reported as "long-term investments."

vestments in buildings or requiring that the principal be maintained permanently or for a specified time period); or (*c*) governing boards, which may designate cash for investment purposes (traditionally known as "funds functioning as endowment" or "quasi endowment").

4.05 Relevant information about the nature and amount of limitations on the use of cash and cash equivalents should be included on the face of the financial statements or in the notes. Information about the nature and amount of donor-imposed restrictions should also be disclosed in the net asset section of the statement of financial position or in the notes to the financial statements.[3] (Chapter 11, "Net Assets," of this Guide, discusses accounting for net assets.) Disclosure in the notes to the financial statements should also be made if unusual circumstances (such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems) are present, or if the organization has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions.[4]

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[3] Paragraph 94 of FASB Statement No. 117 also permits not-for-profit organizations to disaggregate assets into unrestricted and donor-restricted classes when there are donor restrictions on the use of specific donated assets.

[4] Paragraphs 3.25 through 3.27 of this Guide discuss reporting requirements when the organization is not in compliance with donor-imposed restrictions.

Chapter 5

Contributions Received and Agency Transactions

Introduction

5.01 Some not-for-profit organizations receive contributions of cash, other assets, and services from individuals, for-profit organizations, other not-for-profit organizations, and governments. Paragraph 5 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines a contribution as

> an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, material and supplies, intangible assets, services, and unconditional promises to give those items in the future.

5.02 Some inflows of assets are not included in the definition of contributions, as follows:

- Transfers that are exchange transactions, in which both parties receive goods or services of commensurate value
- Transfers in which the organization is acting as an agent, trustee, or intermediary for the donor (that is, the organization has little or no discretion concerning the use of the assets transferred)[1]
- Tax exemptions, tax incentives, and tax abatements

This chapter provides guidance for distinguishing contributions from other kinds of transactions. It also discusses recognition, measurement, and disclosure principles for contribution revenues[2] and related receivables.[3] Chapter 12 of this Guide discusses accounting principles for revenues, gains, and receivables from providing services and from other exchange transactions. Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses reporting contributions made by not-for-profit organizations.

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[1] On December 29, 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. That exposure draft addresses various issues concerning transactions in which a not-for-profit organization acts as an agent, trustee, or intermediary as those terms are used in FASB Statement No. 116.

[2] The classification of contributions received as revenues or gains depends on whether the transactions are part of the organization's ongoing major or central activities, or are peripheral or incidental to the organization. For purposes of this chapter, the term *contribution revenue* is used to apply to either situation. Chapter 12, "Revenues and Receivables From Exchange Transactions," of this Audit and Accounting Guide (Guide), discusses the distinction between ongoing major activities and peripheral or incidental transactions and events.

[3] Unconditional promises to give cash or other financial instruments, such as an ownership interest in an entity, are *financial instruments* as defined in FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk*, as amended by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments.*

Distinguishing Contributions From Other Transactions[4]

5.03 Contributions are transactions in which one entity, acting other than as an owner, makes an unconditional voluntary transfer to another entity without directly receiving equal value in exchange. Some resource providers may be required to transfer assets or provide services to not-for-profit organizations involuntarily; for example, to settle legal disputes or to pay fines. Those transactions are not contributions. Accounting for contributions is different from accounting for other kinds of voluntary transfers, such as conditional transfers, agency transactions, and exchange transactions. Accounting for transfers with donor-imposed conditions is discussed in paragraphs 5.23 through 5.25 of this Guide.

5.04 To determine the accounting for transactions in which an entity voluntarily transfers assets to a not-for-profit organization, it is first necessary to assess the extent of discretion the not-for-profit organization has over the use of the assets that are received. If it has little or no discretion, the transaction is an agency transaction. If it has discretion over the assets' use, the transaction is a contribution, an exchange, or a combination of the two. Not-for-profit organizations should consider the guidance in paragraphs 52 through 54 of FASB Statement No. 116 in distinguishing contributions from agency transactions.[5]

5.05 FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (an interpretation of FASB Statement No. 116),[6] clarifies that not-for-profit organizations that receive assets act as donees or donors, rather than as agents, trustees, or intermediaries, if the resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries. Such unilateral power is often referred to as *variance power*.

Agency Transactions

5.06 Resources received in transactions in which a not-for-profit organization is acting as an agent, trustee, or intermediary for a resource provider (that is, agency transactions) should be reported as increases in assets and liabilities; distributions to third-party recipients should be reported as decreases in those accounts.[7] Cash received and paid in such transactions should be reported as cash flows from operating activities in a statement of cash flows.

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[4] Federal rules specify the classification of certain transactions for purposes other than reporting in conformity with generally accepted accounting principles (GAAP), such as contractual reporting requirements. For example, certain transactions should be classified as federal awards received and expended by not-for-profit organizations. The guidance in this Guide pertains to financial reporting in conformity with GAAP. Classifications in conformity with GAAP may differ from classifications in accordance with federal rules.

[5] As discussed in footnote 1, on December 29, 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. That exposure draft addresses various issues concerning transactions in which a not-for-profit organization acts as an agent, trustee, or intermediary as those terms are used in FASB Statement No. 116.

[6] FASB Interpretation No. 42 was issued in September 1996 and is effective for financial statements issued for fiscal years ending after September 15, 1996, with earlier application encouraged. The Interpretation may be applied either retroactively or by reporting the cumulative effect of the change in the year of the change.

[7] Chapter 6, "Split-Interest Agreements," of this Guide, discusses split-interest and similar agreements in which organizations act as trustee for a resource provider and have a beneficial interest in the assets transferred.

If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net. Additional information about such transactions may be required to be disclosed under FASB Statement No. 57, *Related Party Disclosures*.

Gifts in Kind

5.07 Some not-for-profit organizations receive noncash assets—such as property, equipment, and inventory—from resource providers. Reporting these transfers, sometimes referred to as *gifts in kind*, as agency transactions or as contributions depends on the extent of discretion that the not-for-profit recipient has over the use or subsequent disposition of the assets. Information about gifts-in-kind transactions may be required to be disclosed under FASB Statement No. 57.

5.08 Gifts in kind that can be used or sold should be measured at fair value.[8] In determining fair value, organizations should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the organization, including discounts based on that quantity if the assets had been acquired in exchange transactions. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (*a*) used internally by the not-for-profit organization or for program purposes or (*b*) sold by the organization, the item received should not be recognized.

5.09 Not-for-profit organizations may also receive items, such as tickets, gift certificates, works of art, and merchandise, that are to be used for fund-raising purposes by transferring them to other resource providers (the ultimate resource provider or recipient) during fund-raising events. The ultimate resource provider or recipient may acquire the items in transactions that are part exchange transactions and part contributions.[9] Such gifts in kind can be linked to asset transfers from the original resource providers to the ultimate resource providers (recipients) because they are, in substance, part of the same transaction; these gifts in kind should be reported as contributions and measured at fair value when originally received by a not-for-profit organization. The difference between the amount received for those items from the ultimate resource providers (recipients) and the fair value of the gifts in kind when originally contributed to the organization should be recognized as adjustments to the original contributions when the items are transferred to the ultimate resource providers (recipients). For example, a public radio station receives from the local community theater (the original resource provider) a ticket with a fair value of $75, to be auctioned to the highest bidder; a listener (the ultimate resource provider or recipient) subsequently acquires the ticket at auction for $100. The initial transfer of the ticket to the not-for-profit organization should be reported as a $75 contribution and the ticket should be reported as an asset; an additional $25 contribution should be reported when the ticket is transferred to the listener at auction, and no cost for the ticket should be reported on the statement of activities. If a listener acquires the ticket for $45, rather than $100, a reduction of $30 in contributions should be reported when the ticket is transferred to the listener at auction, because the transfer at auction is part of the transaction that was initiated when the organization received the

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[8] Fair value would generally not increase when a gift in kind is passed from one not-for-profit organization to another. However, fair value could increase if an organization adds value to the gift, such as by cleaning and packaging the gift. Any increases should be evaluated to determine whether the not-for-profit organization did, in fact, add to the fair value of the assets.

[9] Paragraphs 13.17 through 13.22 of this Guide discuss reporting special events associated with an organization's fund-raising efforts.

ticket. Holding the ticket from the time of initial receipt to the time of ultimate transfer at auction does not create a transaction separate from the initial contribution.

Exchange Transactions

5.10 Exchange transactions are reciprocal transfers in which each party receives and sacrifices something of approximately equal value. In some situations, exchange transactions can be easily distinguished from contributions. For example, purchases of assets or payments of employees' salaries clearly are exchange transactions: each party gives up and receives equivalent economic value. In contrast, an example of a contribution is a donation to a not-for-profit organization's mass fund-raising appeal: donors are providing resources in support of the organization's mission and expect to receive nothing of direct value in exchange.

5.11 The cost of premiums (such as postcards or calendars) given to potential donors as part of mass fund-raising appeals is a fund-raising expense, and the classification of the donations received from the appeal as contributions is unaffected by the fact that premiums were given to potential donors. The premiums are not provided to potential donors in exchange for the assets contributed; they can be kept by all those from whom funds are solicited, regardless of whether a contribution is made.

5.12 The cost of premiums (such as coffee mugs) that are given to resource providers to acknowledge receipt of a contribution and that are nominal in value compared with the value of the goods or services donated by the resource provider should also be reported as fund-raising expenses.[10] For example, a not-for-profit organization may provide a coffee mug to people making a contribution of $50 or more; the mug costs the organization $1. The organization should recognize contributions for the total amount contributed and fund-raising expense of $1 for each mug provided to donors.

5.13 Classifying asset transfers as exchange transactions or as contributions may require the exercise of judgment concerning whether a reciprocal transaction has occurred, that is, whether a recipient not-for-profit organization has given up assets, rights, or privileges approximately equal to the value of the assets, rights, or privileges received. Value should be assessed from both the recipient's and the resource provider's points of view and can be affected by a wide variety of factors; for example, resource providers can retain the right to share in the use of or income from an asset provided to the not-for-profit organization.

5.14 Table 5.1 contains a list of indicators that may be helpful in determining whether individual asset transfers are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction. Several kinds of voluntary asset transfers that may be difficult to classify are discussed in the following four paragraphs.

5.15 Some not-for-profit organizations receive dues from their members. These transfers often have elements of both a contribution and an exchange transaction because members receive tangible or intangible benefits from their

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[10] Donors may receive premiums that are greater than nominal in value in connection with some transactions. Such transactions should be reported as part exchange transaction and part contribution. The cost of premiums that are greater than nominal in value should be reported as cost of sales. Chapter 12 of this Guide provides guidance concerning reporting exchange transactions.

membership in the organization. For example, if an organization has annual dues of $100 and the only benefit members receive is a monthly newsletter with a fair value of $25, $25 of the dues are received in an exchange transaction and should be recognized as revenue as the earnings process is completed and $75 of the dues are a contribution. It may be difficult, however, to measure the benefits members receive and to determine whether the value of those benefits is approximately equal to the dues paid by the members. Table 5.2 contains a list of indicators that may be helpful in determining whether membership dues are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

Table 5.1

Indicators Useful in Distinguishing Contributions From Exchange Transactions

Indicator	*Contribution*	*Exchange Transaction*
Recipient not-for-profit organization's (NPO's) intent in soliciting the asset*	Recipient NPO asserts that it is soliciting the asset as a contribution.	Recipient NPO asserts that it is seeking resources in exchange for specified benefits.
Resource provider's expressed intent about the purpose of the asset to be provided by recipient NPO	Resource provider asserts that it is making a donation to support the NPO's programs.	Resource provider asserts that it is transferring resources in exchange for specified benefits.
Method of delivery	The time or place of delivery of the asset to be provided by the recipient NPO to third-party recipients is at the discretion of the NPO.	The method of delivery of the asset to be provided by the recipient NPO to third-party recipients is specified by the resource provider.
Method of determining amount of payment	The resource provider determines the amount of the payment.	Payment by the resource provider equals the value of the assets to be provided by the recipient NPO, or the assets' cost plus markup; the total payment is based on the quantity of assets to be provided.
Penalties assessed if NPO fails to make timely delivery of assets	Penalties are limited to the delivery of assets already produced and the return of the unspent amount. (The NPO is not penalized for nonperformance.)	Provisions for economic penalties exist beyond the amount of payment. (The NPO is penalized for nonperformance.)
Delivery of assets to be provided by the recipient NPO	Assets are to be delivered to individuals or organizations other than the resource provider.	Assets are to be delivered to the resource provider or to individuals or organizations closely connected to the resource provider.

* This table refers to assets. Assets may include services. The terms assets and services are used interchangeably in this table.

Table 5.2

Indicators Useful for Determining the Contribution and Exchange Portions of Membership Dues

Indicator	*Contribution*	*Exchange Transaction*
Recipient NPO's expressed intent concerning purpose of dues payment	The request describes the dues as being used to provide benefits to the general public or to the NPO's service beneficiaries.	The request describes the dues as providing economic benefits to members or to other organizations or individuals designated by or related to the members.
Extent of benefits to members	The benefits to members are negligible.	The substantive benefits to members (for example, publications, admissions, educational programs, and special events) may be available to nonmembers for a fee.
NPO's service efforts	The NPO provides service to members and nonmembers.	The NPO benefits are provided only to members.
Duration of benefits	The duration is not specified.	The benefits are provided for a defined period; additional payment of dues is required to extend benefits.
Expressed agreement concerning refundability of the payment	The payment is not refundable to the resource provider.	The payment is fully or partially refundable if the resource provider withdraws from membership.
Qualifications for membership	Membership is available to the general public.	Membership is available only to individuals who meet certain criteria (for example, requirements to pursue a specific career or to live in a certain area).

5.16 Revenue derived from membership dues in exchange transactions should be recognized over the period to which the dues relate. Nonrefundable initiation and life membership fees received in exchange transactions should be recognized as revenues in the period in which the fees become receivable if future fees are expected to cover the costs of future services to be provided to members. If nonrefundable initiation and life membership fees, rather than future fees, are expected to cover those costs, nonrefundable initiation and life member fees received in exchange transactions should be recognized as revenue over the average duration of membership, the life expectancy of members, or other appropriate time periods.

5.17 Foundations, business organizations, and other types of entities may provide resources to not-for-profit organizations under programs referred to as *grants*, *awards*, or *sponsorships*.[11] Those asset transfers are contributions if the resource providers receive no value in exchange for the assets transferred or if the value received by the resource providers is incidental to the potential public benefit from using the assets transferred. The asset transfers are exchange transactions if the potential public benefit is secondary to the resource providers' potential direct benefits. For example, a grant made by a resource provider to a not-for-profit organization would likely be a contribution if the activity specified by the grant is to be planned and carried out by the not-for-profit organization and the organization has the right to the benefits of carrying out the activity. If, however, the grant is made by a resource provider that provides materials to be tested in the activity and that retains the right to any patents or other results of the activity, the grant would likely be an exchange transaction.

5.18 Some transfers of assets between not-for-profit organizations and governments (such as the sale of goods and services) are exchange transactions. Other transfers of assets between not-for-profit organizations and governments (such as unrestricted support given by state and local governments) are contributions. Other kinds of government transfers (sometimes referred to as *grants*, *awards*, or *appropriations*) have unique characteristics that may make it difficult to determine whether they are contributions or exchange transactions. The indicators described in Table 5.1 provide guidance on how to classify such transfers. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

5.19 As discussed in paragraphs 5.26 through 5.34 and in chapters 3, "Basic Financial Statements," and 11, "Net Assets," of this Guide, classification of net assets and revenues as either unrestricted, temporarily restricted, or permanently restricted depends on the existence or absence of donor-imposed restrictions on contributions. Therefore, resources received in exchange transactions should be classified as unrestricted revenues and net assets, even in circumstances in which resource providers place limitations on the use of the resources. For example, resources received from governments in exchange transactions in which those governments have placed limitations on the use of the resources should be reported as unrestricted revenues and net assets, because those limitations are not donor-imposed restrictions on contributions.

Recognition Principles for Contributions

5.20 Accounting for contributions depends on whether the transfer of assets, including promises to give, is received by the not-for-profit organization

[11] Such resource transfers may also have the characteristics of agency transactions. Paragraphs 5.04 and 5.06 discuss agency transactions.

with donor-imposed conditions, donor-imposed restrictions, or both. A donor-imposed condition specifies a future and uncertain event (for example, a stipulation that the organization must meet a matching requirement) whose occurrence or failure to occur gives the donor the right of return of the assets or releases the donor from the obligation to transfer assets in the future. A promise that contains a condition is considered to be unconditional if the possibility that the condition will not be met is remote.[12] For example, a promise that is conditioned on the not-for-profit organization meeting administrative requirements, such as the filing of an annual financial report, should not be considered conditional if the likelihood of not meeting the administrative requirements is remote. A donor-imposed restriction is a stipulation specifying a use for a contribution that is more specific than the broad limits resulting from the nature and purpose of the organization and from the environment in which it operates.

5.21 Distinguishing between a condition stipulated by a donor and a restriction on the use of a contribution imposed by a donor may require the exercise of judgment. Because of the uncertainty about whether they will be met, conditions imposed by resource providers may cast doubt on whether the resource provider's intent was to make a contribution, to make a conditional contribution, or to make no contribution. As a result of this uncertainty, donor-imposed conditions should be substantially met by the organization before the receipt of assets (including contributions receivable) is recognized as a contribution. In contrast to donor-imposed conditions, donor-imposed restrictions limit the use of the contribution, but they do not change the transaction's fundamental nature from that of a contribution.

5.22 Determining whether a promise is conditional or unconditional can be difficult if the promise contains donor stipulations that do not state clearly whether the right to receive payment or delivery of the promised assets depends on meeting those stipulations. It may be difficult to determine whether those stipulations are conditions or restrictions. In cases of ambiguous donor stipulations, a promise containing stipulations that are not clearly unconditional should be presumed to be a conditional promise.

Donor-Imposed Conditions

5.23 A transfer of assets with a conditional promise to contribute them should be accounted for as a refundable advance until the conditions have been substantially met or the conditions have been explicitly waived by the donor. (Transfers of assets, including promises to give, on which resource providers have imposed conditions should be recognized as contributions if the likelihood of not meeting the conditions is remote.)

5.24 Some conditions attached to contributions may be substantially met in stages rather than because of a single event. A portion of those contributions should be recognized as revenue as each of those stages is met. For example, a resource provider promises to contribute $1 for each $1 of contributions received by a not-for-profit organization, up to $100,000, over the next six months. As contributions are received from other resource providers, the conditions would be met and the promise would become unconditional. For example, if $10,000 is received in the first month from donors, $10,000 of the conditional promise would become unconditional and should be recognized as

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[12] Paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*, defines an event to be *remote* when "the chance of the future event or events occurring is slight."

contribution revenue. Contributions, such as certain contributions made by governments, that are conditioned upon the organization incurring certain qualifying costs, should be recognized as revenue as those costs are incurred.

5.25 Unconditional contributions should be recognized as revenue in the period received.[13] Depending on the kind of benefit received, the organization should also recognize (*a*) an increase in assets (for example, cash, securities, contributions receivable, collections [if capitalized, see chapter 7, "Other Assets," of this Guide], and property and equipment); (*b*) a decrease in liabilities (for example, accounts payable or notes payable); or (*c*) an expense (for example, donated legal services).

Donor-Imposed Restrictions

5.26 Contributions may be received with donor-imposed restrictions. Some restrictions permanently limit the organization's use of contributed assets. Other restrictions are temporary in nature, limiting the organization's use of contributed assets to (*a*) later periods or after specific dates (time restrictions), (*b*) specific purposes (purpose restrictions), or (*c*) both.

5.27 Restrictions may (*a*) be stipulated explicitly by the donor in a written or oral communication accompanying the contribution or (*b*) result implicitly from the circumstances surrounding receipt of the contributed asset—for example, making a gift to a capital campaign whose stated objective is to raise funds for a new building. Contributions of unconditional promises to give with payments due in future periods should be reported as temporarily restricted contributions unless the donor expressly stipulates, or circumstances surrounding the receipt of the promise make clear, that the donor intended it to be used to support activities of the current period.

5.28 Donors can impose restrictions on otherwise unrestricted net assets, as well as on their own contributions. For example, a donor may make a restricted contribution that is conditioned on the not-for-profit organization restricting a stated amount of its unrestricted net assets. Such restrictions that are not reversible without donors' consent result in a reclassification of unrestricted net assets to restricted net assets.

5.29 Unconditional contributions received without donor-imposed restrictions should be reported as unrestricted support that increases unrestricted net assets. Unconditional contributions received with donor-imposed restrictions should be reported as restricted support that increases permanently restricted or temporarily restricted net assets, depending on the nature of the restriction.[14] The permanently restricted classification should be used if the limits imposed on the use of the contributed assets are permanent (for example, contributions of cash or securities that must be invested in perpetuity to provide a permanent source of income for the organization or contributions of permanently restricted collection items or of cash that must be used to purchase permanently restricted collection items). The temporarily restricted classification should be used for contributions if the limitations are temporary

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[13] Unconditional contributions of services and collection items are subject to different recognition criteria. Paragraphs 5.40, 5.41, and 7.06 discuss those transactions.

[14] A subsequent event may arise that raises the possibility that the organization may not satisfy a donor-imposed restriction. Statement on Auditing Standards (SAS) No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), provides guidance on the recognition and disclosure of subsequent events.

(for example, a restriction that contributed assets may be used only after some future date, or for some specific program, or to acquire a specific asset).

5.30 In some situations, an organization may meet donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period in which the contribution is received. In those cases, the contribution (to the extent that the restrictions have been met) may be reported as unrestricted support that increases unrestricted net assets provided that the organization has a similar policy for reporting investment gains and income,[15] reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

5.31 The expiration of donor-imposed restrictions on contributions should be reported in the period or periods in which (*a*) a donor-stipulated time has elapsed (for example, the restriction on a term endowment in which contributed cash is to be invested for ten years expires at the end of the tenth year) or (*b*) a donor-stipulated purpose for which the contribution was restricted has been fulfilled by the organization (for example, the restriction on a contribution to acquire operating supplies expires when those supplies are acquired by the organization). If two or more donor-imposed restrictions are stipulated by the donor, the expiration of the restriction should be reported in the period in which the last remaining restriction is satisfied. Expirations of donor-imposed restrictions should be reported in a statement of activities as reclassifications, decreasing temporarily restricted net assets and increasing unrestricted net assets.

5.32 Expenses may be incurred for purposes for which both unrestricted and temporarily restricted net assets are available. If an expense is incurred for a purpose for which both unrestricted and temporarily restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another specific external source of revenue. For example, an employee's salary may meet donor-imposed restrictions to support the program on which the employee is working. In that situation, the restriction is met to the extent of the salary expense incurred unless incurring the salary will lead to inflows of revenues from a specific external source, such as revenues from a cost reimbursement contract or a conditional promise to give that becomes unconditional when the organization incurs the salary expense.

5.33 Not-for-profit organizations may receive contributions of long-lived assets (such as property and equipment) or of cash and other assets restricted to the purchase of long-lived assets, for which donors have not expressly stipulated how or how long the long-lived asset must be used by the organization or how to use any proceeds resulting from the asset's disposal. An organization may adopt an accounting policy of implying time restrictions on the use of such contributed assets that expire over the assets' expected useful lives. If an organization adopts such a policy, the contributions received should be reported as restricted support that increases temporarily restricted net assets. Depreciation should be recorded over the asset's useful life, and net assets should be reclassified periodically from temporarily restricted to unrestricted as depreciation is recognized. Long-lived assets that are subject to an accounting policy implying time restrictions on the use of contributed long-lived assets

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[15] Paragraph 8.17 discusses the accounting policy for reporting investment gains and income if the organization meets donor-imposed restrictions on all or a portion of such gains and income in the same reporting period as the gains and income are recognized.

may be disposed of before the end of their useful lives. In those situations, the gains and losses on the disposal of those assets should be reported as changes in unrestricted net assets and a reclassification should be reported for any remaining temporarily restricted net assets.

5.34 Other organizations may adopt a policy of not implying time restrictions on contributions of long-lived assets (or of other assets restricted to the purchase of long-lived assets) received without donor stipulations about how long the contributed assets must be used. If an organization adopts such a policy, contributions of long-lived assets with no donor-imposed time restrictions should be reported as unrestricted support. Contributions of cash and other assets restricted to the acquisition of long-lived assets should be reported as restricted support that increases temporarily restricted net assets; those restrictions expire when the long-lived assets are placed in service by the organization.

Promises to Give

5.35 Not-for-profit organizations may enter into written or oral agreements with donors involving future nonreciprocal transfers of cash, other assets, and services.[16] Such agreements between not-for-profit organizations and potential donors should be reported as contribution revenue and receivables if such agreements are, in substance, unconditional promises to give,[17] even if the promise is not legally enforceable.

5.36 Conditional promises to give cash or other assets (such as securities or property and equipment) should be recognized as contribution revenue and receivables when the conditions are substantially met. Unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received.[18] Depending on the existence and nature of donor-imposed restrictions, unconditional promises to give should be reported either as unrestricted support that increases unrestricted net assets, or as restricted support that increases permanently restricted or temporarily restricted net assets. Use of the *permanently restricted* classification is appropriate if donor-imposed restrictions stipulate that the resources must be maintained permanently (for example, donors' promises to give cash or securities that must be invested in perpetuity). Use of the temporarily restricted classification is appropriate if donor-imposed restrictions (*a*) expire by passage of time or (*b*) can be fulfilled or removed by actions of the organization pursuant to donor stipulations.

5.37 Unconditional promises to give that are due in future periods and are not permanently restricted generally increase temporarily restricted net assets, rather than unrestricted net assets. If, however, the donor explicitly stipulates that the promise to give is to support current-period activities or if other circumstances surrounding the promise make it clear that the donor's in-

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[16] Paragraph 70 of FASB Statement No. 116 notes that "promises to give services generally involve personal services that, if not explicitly conditional, are often implicitly conditioned upon the future and uncertain availability of specific individuals whose services have been promised." It is assumed in the remainder of this chapter that promises to give services are conditional and, hence, not recognized until the services are performed.

[17] Paragraph 6 of FASB Statement No. 116 defines *promise to give* as "a written or oral agreement to contribute cash or other assets to another entity." These items are sometimes referred to as *pledges*, a term that FASB Statement No. 116 and this Guide avoid because it may be misinterpreted. Paragraphs 5.04 and 5.06 discuss agency transactions.

[18] If a contribution is transferred to the ultimate recipient through an agent, the ultimate recipient should recognize the contribution when sufficient verifiable evidence that the agent has received the promise to give or other assets becomes available.

tention is to support current-period activities, unconditional promises to give should be reported as unrestricted support that increases unrestricted net assets.

5.38 Before a promise to give can be recognized, sufficient verifiable evidence should exist documenting that a promise was made by the donor and received by the not-for-profit organization. Such evidence may be included in written or verifiable oral communications, including (*a*) written agreements, (*b*) pledge cards, and (*c*) oral promises documented by tape recordings, written contemporaneous registers, follow-up written confirmations, and other means that permit subsequent verification of the oral communications. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable. Promises to give that do not discuss the specific time or place for the contribution but that are otherwise clearly unconditional in nature should be considered unconditional promises to give.

5.39 Not-for-profit organizations may receive communications that are intentions to give, rather than promises to give. For example, communications from individuals indicating that the organization has been included in the individual's will as a beneficiary are intentions to give. Such communications are not unconditional promises to give, because individuals retain the ability to modify their wills during their lifetimes. (When the probate court declares the will valid, the not-for-profit organization should recognize contribution revenue and a receivable at the fair value of its interest in the estate, unless the promise is conditioned upon future or uncertain events, in which case a contribution should not be recognized until the conditions are substantially met. Not-for-profit organizations should disclose information about conditional promises in valid wills in conformity with paragraph 25 of FASB Statement No. 116.) Solicitations for donations that clearly include wording such as "information to be used for budget purposes only" or that clearly and explicitly allow resource providers to rescind their indications that they will give are intentions to give rather than promises to give and should not be reported as contributions.

Contributed Services

5.40 Contributed services should be reported as contribution revenue and as assets or expenses only if the services create or enhance a nonfinancial (that is, nonmonetary) asset (for example, property and equipment) or—

- Would typically need to be purchased by the organization if they had not been provided by contribution,
- Require specialized skills, and
- Are provided by individuals with those skills (such as accounting, financial, construction, educational, electrical, legal, medical, and other services provided by accountants, investment advisers, contractors, teachers, electricians, lawyers, doctors, and other professionals and craftspeople).

If such contributions are reported, they should be measured at fair value.[19] Examples of situations in which it may be appropriate to recognize contributed services are included in paragraphs 195 to 206 of FASB Statement No. 116.

5.41 Contributed services (and the related assets and expenses) should be recognized if employees of separately governed affiliated organizations regu-

[19] Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the services at their fair value.

larly perform services (in other than an advisory capacity) for and under the direction of the recipient organization and the recognition criteria for contributed services are met.

Contributed Utilities and Use of Long-Lived Assets

5.42 Not-for-profit organizations may receive unconditional contributions of the use of electric, telephone, and other utilities and of long-lived assets (such as a building or the use of facilities) in which the donor retains legal title to the long-lived asset. Organizations receiving such contributions should recognize contribution revenue in the period in which the contribution[20] is received and expenses in the period the utilities or long-lived assets are used.[21] If the transaction is an unconditional promise to give (as described in paragraphs 5.35 through 5.39) for a specified number of periods, the promise should be reported as contributions receivable and as restricted support that increases temporarily restricted net assets.[22]

5.43 Unconditional promises to give the use of long-lived assets (such as a building or other facilities) for a specified number of periods in which the donor retains legal title to the long-lived asset may be received in connection with leases or may be similar to leases but have no lease payments. For example, not-for-profit organizations may use facilities under lease agreements that call for lease payments at amounts below the fair rental value of the property. In such circumstances, the not-for-profit organization should report a contribution for the difference between the fair rental value of the property and the stated amount of the lease payments.[23] (However, amounts reported as contributions should not exceed the fair value of the long-lived asset at the time the organization receives the unconditional promise to give.) The contribution receivable may be described in the financial statements based on the item whose use is being contributed, such as a building, rather than as contributions receivable.

Contributed Collection Items

5.44 Not-for-profit organizations may receive contributions of works of art, historical treasures, and similar items that meet the definition of collections in paragraph 11 of FASB Statement No. 116. The recognition and measurement principles for contributions of collections depend on the collections-capitalization policy adopted by the organization. Accounting for collections is discussed in chapter 7 of this Guide.

Split-Interest Agreements

5.45 A split-interest agreement is a form of contribution in which a not-for-profit organization receives benefits that are shared with other beneficiaries designated by the donor. Common kinds of such agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Because of the specialized nature of these arrangements, they are discussed separately in chapter 6 of this Guide.

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[20] As discussed in paragraph 5.01, contributions include both the use of facilities and utilities, as well as promises to give those items in the future.

[21] Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the utilities or facilities at their fair value.

[22] Paragraphs 5.46 through 5.54 discuss measurement principles for initial recognition of contributions received.

[23] See footnote 20.

Measurement Principles for Contributions

5.46 Contribution revenue should be measured at the fair value of the assets or services received or promised or the fair value of the liabilities satisfied. (Contributions arising from unconditional promises to give that are expected to be collected within one year of the financial statement date may be measured at their net realizable value.) Fair value can best be measured by quoted market prices. If such prices are not available, fair value can be estimated based on one of the following:

- Quoted market prices for similar assets
- The asset's replacement cost
- Independent appraisals of the asset's fair value
- Other valuation techniques, such as discounting the estimated future cash flows

The fair value of contributed services that create or enhance nonfinancial assets should be estimated based on (*a*) the fair value of the services received or (*b*) the fair value of the assets created (or the change in the fair value of the asset that is being enhanced), whichever is more readily determinable.

5.47 Major uncertainties about the existence of value of a contributed asset may indicate that a contribution should not be recognized. Such uncertainties are often present when an item has no use other than for scientific or educational research or for its historical significance. Examples of such items include flora, fauna, photographs, and objects identified with historic persons, places, or events.

5.48 If a promise to give has not previously been recognized as contribution revenue because it was conditional, fair value should be measured when the conditions are met.

5.49 The fair value of contributions arising from unconditional promises to give cash should be determined based on the present value of the estimated future cash flows. Exhibit 5.1 below illustrates initial recognition of unconditional promises to give cash that are expected to be collected one year or more after the financial statement date.

Exhibit 5.1

Initial Recognition of Unconditional Promises to Give Cash

Facts

Assume that a not-for-profit organization receives a promise (or promises from a group of homogeneous donors) to give $100 in five years, that the estimated future cash flows from the promise(s) are $70, and that the present value of the estimated future cash flows is $50.

Solution

dr.	Contributions Receivable	$70	
cr.	Contribution Revenue—Temporarily Restricted		$50
cr.	Discount on Contributions Receivable		$20

(To report contributions receivable and revenue for the present value of the estimated future cash flows.)

[*Note to Readers*: Some organizations may use a subsidiary ledger to retain information concerning the $100 face amount of contributions promised in order to monitor collections of contributions promised.]

5.50 The fair value of contributions arising from unconditional promises to give noncash assets should be determined based on the present value of the expected fair value of the underlying noncash assets expected to be received at the date those assets are expected to be received,[24] if the date is one year or more after the financial statement date. (Both the (*a*) likelihood of the promise being fulfilled[25] and (*b*) expected fair value of those underlying assets, such as the expected fair value per share of a promised equity security, should be considered in determining the expected fair value of the underlying noncash assets expected to be received.) In some cases, the expected fair value of the underlying asset may be difficult to determine. In those cases, the fair value of the underlying asset at the date of initial recognition may be the best estimate of the present value of the expected fair value of the underlying asset. (No discount should be reported if an asset's fair value at the date of initial recognition is used to estimate the present value of the expected fair value of the underlying asset.)

5.51 In determining the estimated future cash flows of unconditional promises to give cash (or, for promises to give noncash assets, the quantity and nature of assets expected to be received), not-for-profit organizations should consider when the receivable is expected to be collected, the creditworthiness of the other parties, the organization's past collection experience and its policies concerning the enforcement of promises to give, and other factors concerning the receivable's collectibility.

Discounting

5.52 The present value of unconditional promises to give should be measured using a risk-free rate of return appropriate for the expected term of the promise to give. (A risk-free rate of return, rather than the donor's borrowing rate, is the discount rate commensurate with the risks involved because, as discussed in paragraph 5.51, the donor's credit rating and other factors affecting the donor's ability to honor the promise to give would be considered in determining the estimated future cash flows of unconditional promises to give cash [or, for promises to give noncash assets, the quantity and nature of assets expected to be received]. Therefore, the amount to be discounted is considered to be free from credit risk.) In conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently.

5.53 Discounts on contributions receivable that are measured at present value should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are received. In conformity with paragraph 15 of APB Opinion No. 21, the interest method should be used to amortize the discount. Other methods of amortization may be used if the results are not materially different. The amount of the periodic amortization of the discount should be included as a component of contribution

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[24] Throughout the remainder of this chapter, the phrase *the expected fair value of the underlying asset* [or *underlying security,* or *underlying noncash asset*] is used to refer to the expected fair value of the underlying asset [or underlying security, or underlying noncash asset] at the date the asset [or security, or noncash asset] is expected to be received.

[25] The quantity, nature, and timing of assets expected to be received, such as the number of shares of a promised equity security, the company in which those shares represent an equity interest, and when those shares will be received should be considered in determining the likelihood of the promise being fulfilled.

revenue and should be reported as an increase in permanently restricted, temporarily restricted, or unrestricted net assets, depending on the net asset class in which the promise was originally reported.

5.54 Contributions receivable should be reported net of the discount that arises when measuring a promise to give at present value. The discount should be separately disclosed by reporting it as a deduction from contributions receivable either on the face of a statement of financial position or in the notes to the financial statements.

Subsequent Measurement

5.55 The fair value of contributions arising from unconditional promises to give cash and noncash assets may change because of (*a*) changes in the quantity or nature of assets expected to be received (such as changes in the amounts of future cash flows), (*b*) changes in the timing of assets expected to be received,[26] and (*c*) changes in the expected fair value of underlying noncash assets.

Changes in the Quantity or Nature of Assets Expected to Be Received

5.56 If the fair value of contributions arising from unconditional promises to give cash or noncash assets decreases because of changes in the quantity or nature of assets expected to be received, the decrease should be recognized in the period(s) in which the expectation changes. Such decreases should be reported as expenses or losses (bad debt) in the net asset class in which the net assets are represented.[27] No increase in net assets should be recognized if the fair value of contributions arising from unconditional promises to give increases because of changes in the quantity or nature of assets expected to be received between the date the unconditional promises to give are recognized and the date they are collected, except as provided in the next sentence. If the fair value of contributions arising from unconditional promises to give increases because of changes in the quantity or nature of assets expected to be received, and previous decreases in the fair value of those promises have resulted in expenses or losses from bad debts, such increases should be reported as recoveries of those expenses or losses, to the extent that those expenses or losses have been recognized, in the net asset classes in which the net assets are represented. Amounts collected, other than recoveries of bad debt expenses or losses, in excess of the carrying amount of contributions receivable should be reported as contribution revenue in the appropriate net asset class.

Changes in the Fair Value of Underlying Noncash Assets

5.57 As discussed in paragraph 5.55, the fair value of contributions arising from unconditional promises to give noncash assets may change because of changes in the expected fair value of the underlying noncash assets. If, in a period subsequent to initial measurement, an observed change in the

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[26] The FASB's Present-Value-Based Measurements project is addressing questions about accounting measurements based on the present value of future inflows and outflows of cash and other assets (interest methods). Accordingly, this Guide does not address accounting for changes in the timing of assets expected to be received.

[27] As discussed in chapters 3 and 13 of this Guide, all expenses should be reported as decreases in unrestricted net assets. Therefore, decreases in contributions because of changes in the amounts of assets expected to be received should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

current fair value of the asset to be contributed occurs, that change in fair value may or may not result in changes in the expected fair value of the underlying noncash asset, depending on the method and assumptions used for determining the expected fair value of the underlying noncash asset. For purposes of subsequent measurement, the method for determining the expected fair value of the underlying noncash asset should be the same as the method used for determining that amount for purposes of initial measurement. (Paragraph 5.50 discusses the measurement principles for initial recognition of unconditional promises to give noncash assets, including consideration of the expected fair value of the underlying asset.) Accordingly, assumed relationships, such as the relationship between the market price of the noncash asset at the time the initial measurement is made and its projected market price at the date the asset is expected to be received, should be presumed to continue in determining whether the expected fair value of the underlying noncash asset has changed. (As discussed in paragraph 5.50, the fair value of the underlying noncash asset at the date of initial recognition may be the best estimate of the present value of the expected fair value of the underlying noncash asset. If that method is used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed should be treated as if they were changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the expected fair value of the underlying asset. If that method is not used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed may or may not result in changes in the expected fair value of the underlying asset, and, therefore, may or may not result in changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the expected fair value of the underlying asset.)

5.58 Paragraph 5.59 discusses accounting for changes in the fair value of contributions arising from unconditional promises to give equity securities with readily determinable fair values or debt securities because of changes in the expected fair value of the underlying securities. Paragraph 5.60 discusses accounting for changes in the fair value of contributions arising from unconditional promises to give noncash assets other than equity securities with readily determinable fair values or debt securities because of changes in the expected fair value of the underlying noncash assets.

5.59 The fair value of contributions arising from unconditional promises to give equity securities with readily determinable fair values or debt securities may change between the date the unconditional promise to give is recognized and the date the asset promised is received because of changes in the expected fair value of the underlying securities. Such changes should be reported as increases and decreases in contribution revenue in the period(s) in which the change occurs, in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented.

5.60 The fair value of contributions arising from unconditional promises to give noncash assets other than equity securities with readily determinable fair values or debt securities may decrease between the date the unconditional promise to give is recognized and the date the asset promised is received because of decreases in the expected fair value of the underlying noncash assets. Such decreases should be reported as decreases in contribution revenue in the period(s) in which the decrease occurs, in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented. No additional revenue should be recognized if the expected fair value of those underlying noncash assets increases between the date the unconditional promise to give is recognized and the date the asset promised is received.

Illustration

5.61 Table 5.3 below illustrates the accounting for changes in the fair value of contributions subsequent to initial recognition but before collection.

Table 5.3

Accounting for Changes in Fair Value of Contributions (Subsequent to Initial Recognition But Before Collection)

	Reason for the Change in Fair Value			
Underlying Asset	*Change in Collectibility of the Receivable*		*Change in the Expected Fair Value of the Underlying Asset*	
	Increase in Fair Value	*Decrease in Fair Value*	*Increase in Expected Fair Value*	*Decrease in Expected Fair Value*
Cash	No adjustment*	Recognize expense or loss (bad debt)	Not applicable	Not applicable
FASB No. 124 securities**	No adjustment*	Recognize expense or loss (bad debt)	Recognize additional contribution revenue	Recognize a decrease in contribution revenue
Other assets	No adjustment*	Recognize expense or loss (bad debt)	No adjustment	Recognize a decrease in contribution revenue

* Recoveries of previously recognized decreases in fair value resulting from changes in estimates of collectibility (up to the amount of decreases previously recognized), however, should be recognized as reductions of bad debt expense or loss.

** For purposes of this table, *FASB No. 124 securities* are defined as equity securities with readily determinable fair values and all debt securities.

Financial Statement Presentation

5.62 *Contribution revenue* may be reported as a separate line item on a statement of activities. However, this does not preclude reporting separate line items for government contracts, membership dues,[28] special events, or similar revenue sources in other revenue categories or in the notes to the financial statements.

[28] Accounting for the portion of membership dues that is an exchange transaction is different than accounting for the portion that is a contribution. Paragraphs 5.15 and 5.16 discuss revenue recognition principles for membership dues.

5.63 The notes to the financial statements should also include the following:

- The accounting policies adopted by the organization concerning the following:
  - — Whether the organization implies time restrictions on the use of contributed long-lived assets (and contributions of cash and other assets restricted to purchasing them) received without donor stipulations about how long the contributed assets must be used (Paragraphs 5.33 and 5.34 provide guidance concerning the application of this policy.)
  - — Whether the organization classifies donor-restricted contributions as unrestricted or restricted support if restrictions are satisfied in the same reporting period in which the contributions are received (Paragraph 5.30 provides guidance concerning the application of this policy.)
  - — Whether the organization recognizes contributions of collection items (Paragraphs 7.05 through 7.09 provide guidance concerning the application of this policy.)
- Disclosures relating to the liquidity of the organization's contributions receivable, including the following:
  - — Contributions receivable pledged as collateral or otherwise limited as to use
  - — A schedule of unconditional promises to give (showing the total amount separated into amounts receivable in less than one year, in one to five years, and in more than five years) and the related allowance for uncollectible promises receivable arising from subsequent decreases due to changes in the quantity or nature of assets expected to be received (see paragraph 5.56), and the unamortized discount[29]
  - — The amount of conditional promises to give—in total and, with descriptions, the amount of each group of similar promises (for example, those conditioned upon the development of new programs, upon the purchase or construction of new property and equipment, and upon the raising of matching funds within a specified time period)
- Disclosures required by APB Opinion No. 21

5.64 The notes to the financial statements should include the following disclosures concerning contributions of services received during the period:

- The nature and extent of contributed services received by the organization
- A description of the programs or activities for which the services were used
- The amount of contributed services recognized during the period

Not-for-profit organizations are encouraged to report in the notes to the financial statements, if practical, the fair value of contributed services received but not recognized.

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[29] The amount of unconditional promises to give included in the schedule represents amounts reported as contributions receivable. For example, assume that, on the last day of its fiscal year, an organization receives promises to give $100 in five years, that the estimated future cash flows from the promises are $70, and that the present value of the estimated future cash flows is $50. The notes to the financial statements should disclose unconditional promises to give of $70 and unamortized discount of $20.

Illustrative Disclosures

5.65 The following section provides examples of notes to financial statements that illustrate some of the disclosures discussed in this chapter.

Example 1—Donor-Imposed Restrictions

Note X: Summary of Significant Accounting Policies

All contributions are considered to be available for unrestricted use unless specifically restricted by the donor. Amounts received that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted support that increases those net asset classes. However, if a restriction is fulfilled in the same time period in which the contribution is received, the organization reports the support as unrestricted.

Example 2—Promises to Give

Note X: Summary of Significant Accounting Policies

Unconditional promises to give that are expected to be collected within one year are recorded at net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. The discounts on those amounts are computed using risk-free interest rates applicable to the years in which the promises are received. Amortization of the discounts is included in contribution revenue. Conditional promises to give are not included as support until the conditions are substantially met.

Note Y: Promises to Give

Included in "Contributions Receivable" are the following unconditional promises to give:

	19X1	*19X0*
Capital campaign	$1,220	
Restricted to future periods	795	$530
Unconditional promises to give before unamortized discount and allowance for uncollectibles	2,015	530
Less: Unamortized discount	(180)	(24)
Subtotal	1,835	506
Less: Allowance for uncollectibles	(150)	(30)
Net unconditional promises to give	$1,685	$476
Amounts due in:		
Less than one year	$1,220	
One to five years	725	
More than five years	70	
Total	$2,015	

Discount rates ranged from 4 percent to 4.5 percent and from 3.5 percent to 4 percent for 19X1 and 19X0, respectively.

In 19X0, the organization received $650 for a capital campaign which must be returned if the organization does not receive $1,300 in donations to the capital campaign. The $650 received was recorded on the 19X0 statement of financial position as a refundable advance. In 19X1, the organization received $500 in cash donations and $865 in unconditional promises to give to this campaign. As a result, the $650 was recognized as temporarily restricted contributions in 19X1.

In addition, the organization received the following conditional promises to give that are not recognized as assets in the statements of financial position:

	19X1	*19X0*
Conditional promise to give upon the establishment of a library program	$ 100	$100
Conditional promise to give upon obtaining $2,500 in unconditional promises to give to the capital campaign	5,000	

[*The following disclosure is encouraged but not required.*]

The organization received an indication of an intention to give from an individual long-time donor. The anticipated gift is an extensive collection of pre-Columbian textiles with great historical and artistic significance. The value of this intended gift has not been established, nor has the gift been recognized as an asset or contribution revenue.

Example 3—Accounting Policy for Contributed Property and Equipment

Note X: Summary of Significant Accounting Policies

Contributed property and equipment is recorded at fair value at the date of donation. In the absence of donor stipulations regarding how long the contributed assets must be used, the organization has adopted a policy of implying a time restriction on contributions of such assets that expires over the assets' useful lives. As a result, all contributions of property and equipment, and of assets contributed to acquire property and equipment, are recorded as restricted support.

OR

Contributed property and equipment is recorded at fair value at the date of donation. If donors stipulate how long the assets must be used, the contributions are recorded as restricted support. In the absence of such stipulations, contributions of property and equipment are recorded as unrestricted support.

Example 4—Contributed Services

The organization recognizes contribution revenue for certain services received at the fair value of those services. Those services include the following items:

	19X1	*19X0*
Home outreach program:		
Salaries:		
Social work interns—261 and 315 hours at $12.00 per hour	$ 3,132	$ 3,780
Registered nurse—200 and 220 hours at $15.00 per hour	3,000	3,300
Total salaries	6,132	7,080
Management and general:		
Accounting services	10,000	19,000
Total contributed services	$16,132	$26,080

In addition, approximately 80,000 hours, for which no value has been assigned, were volunteered by tutors in the home outreach program.

Auditing

5.66 Since for-profit organizations do not usually receive contributions or enter into agency transactions, the specific audit objectives, selected controls, and auditing procedures related to contributions, contributions receivable, and agency transactions are unique to not-for-profit organizations and are presented below.

5.67 Not-for-profit organizations that receive significant amounts of contributions should have an accounting system, along with controls built into that system, for recording the receipt and collection of contributions. Internal control should also provide reasonable assurance that revenues arising from conditional promises to give are recognized when the conditions have been substantially met and that restrictions on contributions are recognized in the appropriate net asset class. The absence of such an accounting system and related controls might make it difficult for the auditor to obtain the necessary assurance about the completeness assertion and the presentation and disclosure assertion for contribution revenues and receivables and net assets. Accordingly, the auditor's assessment of control risk with respect to assertions related to contribution revenues and receivables may constitute a major activity in the planning process.

5.68 Paragraph 34 of SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), states that "confirmation of accounts receivable is a generally accepted auditing procedure," and that there is a presumption that the auditor will request the confirmation of accounts receivable except under certain specified circumstances. That paragraph defines *accounts receivable* as "(*a*) the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and (*b*) a financial institution's loans." Though under that definition contributions receivable are not accounts receivable to which that presumption would apply, the auditor may nevertheless decide to request confirmation of contributions receivable.

5.69 Receivables are usually confirmed principally to provide evidence about the existence/occurrence assertion. FASB Statement No. 116 specifies that for a promise to give to be recognized in financial statements, there must be sufficient evidence in the form of verifiable documentation that a promise was received. If the documentation is not present, an asset should not be recognized. The verifiable documentation required by Statement No. 116 for recognition of promises to give may not be sufficient evidence concerning the existence/occurrence assertion. Confirming recorded promises to give (contributions receivable) may provide additional evidence about the existence of promises to give, the existence or absence of restrictions, the existence or absence of conditions, and the periods over which the promises to give become due. If the auditor confirms promises to give, he or she should follow the guidance in SAS No. 67 concerning the confirmation process.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Contribution Revenues and Receivables			
Existence/ occurrence	Amounts recognized as contribution revenues and related receivables represent valid unconditional contributions and promises to give.	Controls ensure that only unconditional contributions and promises to give are recognized in the financial statements.	Examine documentation supporting recognition of contribution revenues and promises to give, including information such as absence of conditions and the periods over which the promises to give become due.
Completeness	All unconditional contributions and promises to give are recognized.	Controls ensure that all unconditional contributions and promises to give are recognized in the financial statements. Controls ensure that conditional promises to give are recognized when the conditions have been substantially met.	Compare detailed receivables from promises to give with data accumulated and maintained by the fund-raising function and investigate reconciling items.
Valuation	Contribution revenues and related receivables are appropriately valued.	Controls ensure the appropriate valuation of contribution revenue and promises to give at the time of initial recognition.	Review and test the methods used to measure contribution revenue and promises to give at the time of initial recognition.
		The valuation of promises to give is periodically	Review promises to give for collectibility and,

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
		reviewed by management.	if appropriate, changes in fair value of the underlying asset.
		Writeoffs of uncollectible promises to give are identified and approved in accordance with the entity's established policy.	
Presentation and Disclosure	Restricted contributions are reported in the proper net asset class.	Contributions are reviewed for restrictions and other limitations.	Review the documentation underlying contributions and promises to give (including donor correspondence and governing board minutes) for propriety of classification.
	Disclosures related to contributions are proper.		Determine the appropriateness of disclosures for conditional and unconditional promises to give.
Contributed Services, Utilities, Facilities, and Use of Long-Lived Assets			
Existence/ occurrence; completeness; valuation; presentation and disclosure	Assets, expenses, and revenues from contributed services, utilities, facilities, and use of long-lived assets meet the appropriate recognition criteria; all such contributions that meet the recognition criteria are recognized and	Controls ensure that only contributed services, utilities, facilities, and use of long-lived assets that meet the appropriate recognition criteria are recognized; controls ensure that all such contributions that meet the	Review the documentation underlying recognition of contributed services, utilities, facilities, and use of long-lived assets for completeness and propriety of amounts recognized, presented, and disclosed.

Financial Statement Assertions	Specific Audit Objectives	Examples of Selected Controls	Examples of Auditing Procedures
	appropriately measured, presented, and disclosed.	recognition criteria are recognized and appropriately measured, presented, and disclosed.	
Agency Transactions			
Existence/ occurrence; completeness	Assets and liabilities from agency transactions meet the criteria for classification and recognition as agency transactions.	Controls ensure that (1) only resources received and paid in agency transactions are classified and recognized as agency transactions and (2) all such transactions are recognized.	Review the documentation underlying the receipt of assets from resource providers that will be transferred to others for propriety of classification and recognition.
	All agency transactions are recognized.		Review the documentation underlying the distribution of assets to others for propriety of classification and recognition.
			Review the historical patterns of the distribution of gifts in kind and other assets to determine the extent of the organization's discretion over those distributions.

Chapter 6

Split-Interest Agreements[1]

Introduction

6.01 Some donors enter into trust or other arrangements under which not-for-profit organizations receive benefits that are shared with other beneficiaries. Recognition and measurement principles for these arrangements, commonly known as *split-interest agreements*, are discussed in this chapter. The application of these principles to five widely used types of such agreements—charitable lead trusts, perpetual trusts held by third parties,[2] charitable remainder trusts, charitable gift annuities, and pooled (life) income funds—is also illustrated.

Types of Split-Interest Agreements

6.02 Under a split-interest agreement, a donor makes an initial gift to a trust or directly to the not-for-profit organization, in which the not-for-profit organization has a beneficial interest but is not the sole beneficiary. The terms of some agreements do not allow donors to revoke their gifts; other agreements may be revocable by donors in certain situations. The time period covered by the agreement is expressed either as a specific number of years (or in perpetuity) or as the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. At the end of the agreement's term, the remaining assets covered by the agreement are distributed to or retained by either the not-for-profit organization or another beneficiary or beneficiaries.

6.03 Under some kinds of agreements, referred to in this Audit and Accounting Guide (Guide) as *lead interests*, the not-for-profit organization receives the distributions during the agreement's term. In other kinds of agreements, referred to as *remainder interests*, the donor (or other individuals or organizations designated by the donor) receives those distributions and the not-for-profit organization receives all or a portion of the assets remaining at the end of the agreement's term. Under either kind of agreement, donors may impose restrictions on the not-for-profit organization's use of all or a portion of any assets received.

Recognition and Measurement Principles

6.04 Not-for-profit organizations should report irrevocable split-interest agreements. Assets received under those agreements should be recorded at

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[1] The Financial Accounting Standards Board (FASB) currently has a project on its agenda on consolidations and related matters and has released an October 16, 1995, exposure draft, *Consolidated Financial Statements: Policy and Procedures*, in connection with that project. That project may modify the conclusions in this Guide.

[2] Though perpetual trusts held by third parties may not meet the definition of a split-interest agreement because the not-for-profit organization may be the sole beneficiary, they are included in this chapter because they present some of the same accounting issues as do split-interest agreements.

their fair value when received.[3] Assets held under such agreements as investments should be reported in conformity with the guidance in chapter 8, "Investments," of this Guide. The contribution portion of an agreement (that is, the part that represents the unconditional transfer of assets in a voluntary nonreciprocal transaction) should be recognized as revenue or gain.[4] Liabilities incurred in the exchange portion of an agreement (usually an agreement to pay an annuity to the donor) should also be recognized.

6.05 In the absence of donor-imposed conditions, not-for-profit organizations should recognize contribution revenue and related assets and liabilities when irrevocable split-interest agreements naming them trustee or fiscal agent are executed. If an unrelated third party (for example, a bank, trust company, or private individual) acts as trustee or fiscal agent, a contribution should be recognized when the not-for-profit organization is notified of the agreement's existence. If the third party has substantive discretion over to whom benefits are distributed, the agreement should be considered an intention to give by the not-for-profit organization.[5] Contribution revenue should not be recognized under such agreements until the organization has an unconditional right to receive benefits under the agreement.

Recognition of Revocable Agreements

6.06 Revocable split-interest agreements should be accounted for as intentions to give. Assets received by not-for-profit organizations acting as a trustee under revocable split-interest agreements should be recognized at fair value when received and as refundable advances. (Contribution revenue for the assets received should be recognized when the agreements become irrevocable or when the assets are distributed to the not-for-profit organization for its unconditional use, whichever occurs first.) Assets held under such agreements as investments should be reported in conformity with the guidance in chapter 8. Income earned on assets held under such agreements that is not available for the organization's unconditional use, and any subsequent adjustments to the carrying value of those assets, should be recognized as adjustments to the assets and as refundable advances.

Initial Recognition of Unconditional Irrevocable Agreements

6.07 At the date of initial recognition of a split-interest agreement, contributions should be measured at fair value. Under a lead interest agreement, the fair value of the contribution can be estimated directly based on the present value of the estimated future distributions expected to be received by the not-

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[3] Some split interest agreements include promises to give noncash assets, such as homes. Paragraph 5.50 of this Guide includes guidance concerning determining the fair value of unconditional promises to give noncash assets.

[4] As discussed in footnote 2 to chapter 5, "Contributions Received and Agency Transactions," of this Guide, contributions may be reported as revenues or gains, depending on whether they are part of the organization's ongoing major activities or are peripheral or incidental transactions. For purposes of this chapter, the term *contribution revenue* is used to apply to either situation.

[5] If the third party is a not-for-profit organization, it may have received the resources as a contribution or as an agency transaction. Paragraphs 52 through 54 of FASB Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, include guidance concerning distinguishing contributions from agency transactions. On December 29, 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. That exposure draft addresses various issues concerning transactions in which a not-for-profit organization acts as an agent, trustee, or intermediary as those terms are used in FASB Statement No. 116.

for-profit organization as a beneficiary. Under a remainder interest agreement, future distributions will be received by the not-for-profit organization only after obligations to other beneficiaries are satisfied. In those cases, the fair value of the contribution may be estimated based on the fair value of the assets contributed by the donor less the present value of the payments expected to be made to other beneficiaries. Any method for measuring the fair value of the contribution must consider (*a*) the estimated return on the invested assets during the expected term of the agreement, (*b*) the contractual payment obligations under the agreement, and (*c*) a discount rate commensurate with the risks involved.[6] In conformity with paragraph 12 of Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the contribution is initially recognized and should not be revised subsequently.

6.08 Contribution revenues recognized under split-interest agreements should be classified as increases in temporarily restricted net assets unless the donor has permanently restricted the organization's use of its interest (lead or remainder) in the assets or the donor gives the organization the immediate right to use without restrictions the assets it receives.[7] If the donor has permanently restricted the organization's use of its interest, the contribution should be classified as an increase in permanently restricted net assets. If the organization has the immediate right to use its interest without restrictions, the contribution should be classified as increases in unrestricted net assets.

6.09 When a not-for-profit organization serves as trustee or when the assets contributed by the donor are otherwise under the control of the not-for-profit organization, cash and other assets received under split-interest agreements should be recognized at fair value at the date of initial recognition. If those assets, or a portion of those assets, are being held for the benefit of others, such as the donor or third parties designated by the donor, a liability, measured at the present value of the expected future payments to be made to other beneficiaries, should also be recognized at the date of initial recognition.[8] In some cases, such as under remainder interest agreements, the present value of the expected future payments to be made to other beneficiaries can be estimated directly based on the terms of the agreement. In other cases, such as under lead interest agreements, the future payments will be made by the not-for-profit organization only after the organization receives its benefits. In those situations, the present value of the future payments to be made to other beneficiaries may be estimated by the fair value of the assets contributed by the donor under the agreement less the present value of the estimated benefits to be received by the not-for-profit organization.

6.10 In arrangements in which cash or other assets contributed by donors under split-interest agreements are held by independent trustees or by other

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[6] Reference to Internal Revenue Service (IRS) guidelines and actuarial tables used in calculating the donor's charitable deduction for income tax purposes may be helpful in assessing the reasonableness of the method used for measuring fair value.

[7] Under many charitable gift annuity agreements, the assets received from the donor are held by the not-for-profit organization as part of its general assets and are available for its unrestricted use.

[8] Additional annuity reserves may be required by the laws of the state where the not-for-profit organization is located or by the state where the donor resides. Legally mandated reserves should be disclosed in the notes to the financial statements. In addition, some not-for-profit organizations voluntarily set aside additional reserves as a cushion against unexpected actuarial losses. Voluntary reserves should be included as part of unrestricted net assets, but may be disclosed as a separate component, such as board-designated unrestricted net assets (see chapter 11, "Net Assets," of this Guide).

fiscal agents of the donors or are otherwise not controlled by the not-for-profit organization, the not-for-profit organization should recognize its beneficial interest in those assets. Contribution revenue and a receivable should be measured at the present value of the estimated future distributions expected to be received by the organization over the expected term of the agreement.

Recognition During the Agreement's Term

6.11 During the term of the agreement, the following transactions and events should be recognized as "changes in the value of split-interest agreements" in a statement of activities and classified as temporarily restricted, permanently restricted, or unrestricted net assets, depending on the classification used when the contribution revenue was recognized initially: (*a*) amortization of the discount associated with the contribution and (*b*) revaluations of expected future payments to beneficiaries, based on changes in life expectancy, and other actuarial assumptions.[9]

6.12 When assets held in trust and related liabilities are recognized under lead and remainder interest agreements for which a not-for-profit organization serves as a trustee or fiscal agent, income earned on those assets, gains and losses, and distributions made to other beneficiaries under the agreements should be reported in the organization's statements of financial position, activities, and cash flows.

6.13 Amounts should be reclassified from temporarily restricted net assets to unrestricted net assets as distributions are received by not-for-profit organizations under the terms of split-interest agreements, unless those assets are otherwise temporarily restricted by the donor. In that case, they should be reclassified to unrestricted net assets when the restrictions expire.

Recognition Upon Termination of Agreement

6.14 Upon termination of a split-interest agreement, asset and liability accounts related to the agreement should be closed. Any remaining amounts in the asset or liability accounts should be recognized as changes in the value of split-interest agreements and classified as changes in permanently restricted, temporarily restricted, or unrestricted net assets, as appropriate. If assets previously distributed to the not-for-profit organization become available for its unrestricted use upon termination of the agreement, appropriate amounts should be reclassified from temporarily restricted to unrestricted net assets.

Financial Statement Presentation

6.15 Assets and liabilities recognized under split-interest agreements should be disclosed separately from other assets and liabilities in a statement of financial position or in the related notes. Contribution revenue and changes in the value of split-interest agreements recognized under such agreements should also be disclosed as separate line items in a statement of activities or in the related notes. The notes to the financial statements should include the following disclosures related to split-interest agreements:

- A description of the general terms of existing split-interest agreements

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[9] As discussed in paragraph 5.52, the discount rate should not be revised subsequent to initial recognition.

- The basis used (for example, cost, lower of cost or market, fair market value) for recognized assets
- The discount rates and actuarial assumptions used in calculating present values

Examples of Split-Interest Agreements

6.16 Many kinds of split-interest agreements have been developed. The examples in this section demonstrate how the recognition and measurement principles discussed in this chapter apply to some common kinds of agreements. The appendix [paragraph 6.39] to this chapter provides journal entries related to these examples.

Charitable Lead Trust

6.17 A charitable lead trust is an arrangement in which a donor establishes and funds a trust with specific distributions to be made to a designated not-for-profit organization over a specified period. The organization's use of the assets distributed may be restricted by the donor. The distributions may be for a fixed dollar amount, an arrangement called a charitable lead annuity trust (CLAT), or for a fixed percentage of the trust's fair market value as determined annually, a charitable lead unitrust (CLUT). Upon termination of the trust, the remainder of the trust assets is paid to the donor or to the beneficiaries designated by the donor.

6.18 For example, not-for-profit organization A receives cash from a donor under an irrevocable charitable lead annuity trust agreement designating the organization as trustee and lead beneficiary. Under the terms of the trust, organization A will invest the assets and receive a specified dollar amount each year for its unrestricted use until the death of the donor. At that time, the remaining assets in the trust revert to the donor's estate.

6.19 Contribution revenue, assets held in trust, and a liability for amounts held for others should be recognized by organization A in the period in which the trust is established. Revenue should be reported as temporarily restricted support and measured at the present value of the specified dollar amount to be received annually over the expected life of the donor. The assets held in trust by organization A should be recorded at fair value at the date of initial recognition. The difference between the fair value of the assets received and the contribution revenue represents the present value of the liability to pay the donor's estate upon the termination of the trust.

6.20 In subsequent periods, both the income earned on the trust assets and recognized gains and losses should be reflected in the trust asset and liability accounts. Adjustments of the liability to reflect amortization of the discount and revaluations of the future cash flows based on revisions in the donor's life expectancy should be recognized as changes in the value of split-interest agreements and classified as changes in temporarily restricted net assets in a statement of activities. Amounts should be reclassified from temporarily restricted to unrestricted net assets as the annual distributions to organization A are made and recognized during the term of the trust. Upon the death of the donor, the assets are distributed to the donor's estate, the asset and liability accounts are closed, and any difference between the balances in those accounts should be recognized as a change in the value of split-interest agreements in the temporarily restricted net asset class.

6.21 If organization A is not the trustee and does not exercise control over the trust's assets, it should recognize its beneficial interest in those assets as temporarily restricted contribution revenue and as a receivable, measured at the present value of the expected future cash inflows. Distributions from the trust should be reflected as a reduction in the receivable and as reclassifications from temporarily restricted net assets to unrestricted net assets. Amortization of the discount and revaluations of expected future cash flows based on revisions in the donor's life expectancy should be recognized as adjustments to the receivable and as changes in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class. Any balance in the receivable account remaining upon termination of the trust should be recognized as a change in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class.

Perpetual Trust Held by a Third Party

6.22 A perpetual trust held by a third party is an arrangement in which a donor establishes and funds a perpetual trust administered by an individual or organization other than the not-for-profit beneficiary. Under the terms of the trust, the not-for-profit organization has the irrevocable right to receive the income earned on the trust assets in perpetuity, but never receives the assets held in trust. Distributions received by the organization may be restricted by the donor.

6.23 For example, a donor establishes a trust with the donor's bank serving as trustee. Funds contributed to the trust are to be invested in perpetuity. Under the terms of the trust, not-for-profit organization B is to be the sole beneficiary and is to receive annually the income on the trust's assets as earned in perpetuity. Organization B can use the distributions from the trust in any way that is consistent with its mission.

6.24 The arrangement should be recognized by organization B as contribution revenue and as an asset when the organization is notified of the trust's existence. The fair value of the contribution should be measured at the present value of the estimated future cash receipts from the trust's assets.[10] The contribution should be classified as permanently restricted support, because the trust is similar to donor restricted permanent endowment that the organization does not control, rather than a multiyear promise to give. Annual distributions from the trust are reported as investment income that increase unrestricted net assets. Adjustments to the amount reported as an asset, based on an annual review using the same basis as was used to measure the asset initially, should be recognized as permanently restricted gains or losses.

Charitable Remainder Trust

6.25 A charitable remainder trust is an arrangement in which a donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust. The not-for-profit organization may ultimately have unrestricted use of those assets, or the donor may place permanent or temporary restrictions on

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[10] That value may generally be measured by the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the assets contributed to the trust differs from the present value of the expected future cash flows.

their use. The distributions to the beneficiaries may be for a specified dollar amount, an arrangement called a charitable remainder annuity trust (CRAT), or for a specified percentage of the trust's fair market value as determined annually, a charitable remainder unitrust (CRUT). Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or the actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

6.26 For example, a donor establishes a charitable remainder unitrust, with not-for-profit organization C serving as trustee. Under the trust's terms, the donor's spouse is to receive an annual distribution equal in value to a specified percentage of the fair market value of the trust's assets each year until the spouse dies. The income earned on the trust's assets must remain in the trust until the spouse dies. At that time, the remaining assets of the trust are to be distributed to organization C for use as a permanent endowment.

6.27 Organization C should recognize the contribution in the period in which the trust is established. The assets held in trust by organization C should be recorded at fair value when received, and the liability to the donor's spouse should be recorded at the present value of the estimated future payments to be distributed over the spouse's expected life. The amount of the contribution is the difference between these amounts and should be classified as permanently restricted support.

6.28 In subsequent periods, income earned on trust assets, recognized gains and losses, and distributions paid to the spouse should be reflected in the organization's statement of financial position. Adjustments to the liability to reflect amortization of the discount, revaluations of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions should be recognized in a statement of activities as a change in the value of split-interest agreements in the permanently restricted net asset class. Upon the death of the spouse, the liability should be closed and any balance should be recognized as a change in the value of split-interest agreements in the statement of activities in the permanently restricted net asset class.

6.29 If organization C is not the trustee and does not exercise control over the assets contributed to the trust, the agreement should be recognized as an unconditional promise to give. Organization C should recognize, as permanently restricted contribution revenue and as a receivable, the present value of the estimated future benefits to be received when the trust assets are distributed. Adjustments to the receivable to reflect amortization of the discount, revaluation of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions during the term of the trust should be recognized as changes in the value of split-interest agreements. Upon the death of the spouse, the receivable is closed, the assets received from the trust are recognized at fair value, and any difference is reported as a change in the value of split-interest agreements in permanently restricted net assets.

Charitable Gift Annuity

6.30 A charitable gift annuity is an arrangement between a donor and a not-for-profit organization in which the donor contributes assets to the organization in exchange for a promise by the organization to pay a fixed amount for a specified period of time to the donor or to individuals or organizations designated by the donor. The agreements are similar to charitable remainder annuity trusts except that no trust exists, the assets received are held as general assets of the not-for-profit organization, and the annuity liability is a general obligation of the organization.

6.31 For example, not-for-profit organization D and a donor enter into an arrangement whereby assets are transferred from the donor to organization D. Organization D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies.

6.32 Organization D should recognize the agreement in the period in which the contract is executed. The assets received should be recognized at fair value when received, and an annuity payment liability should be recognized at the present value of future cash flows expected to be paid to the donor's spouse. Unrestricted[11] contribution revenue should be recognized as the difference between these two amounts.

6.33 In subsequent periods, payments to the donor's spouse reduce the annuity liability. Adjustments to the annuity liability to reflect amortization of the discount and changes in the life expectancy of the donor's spouse should be recognized in a statement of activities as changes in the value of split-interest agreements in unrestricted net assets. Upon the death of the donor's spouse, the annuity liability should be closed and a change in the value of split-interest agreements should be recognized in the statement of activities.

Pooled (Life) Income Fund

6.34 Some not-for-profit organizations form, invest, and manage pooled (or life) income funds.[12] These funds are divided into units, and contributions of many donors' life income gifts are pooled and invested as a group. Donors are assigned a specific number of units based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund. Until a donor's death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of these assigned units reverts to the not-for-profit organization.

6.35 For example, a donor contributes assets to not-for-profit organization E's pooled (life) income fund and is assigned a specific number of units in the pool. The donor is to receive a life interest in any income earned on those units. Upon the donor's death, the value of the units is available to organization E for its unrestricted use.

6.36 Organization E should recognize its remainder interest in the assets received as temporarily restricted contribution revenue in the period in which

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[11] The contribution portion of a charitable gift annuity agreement should be recognized as unrestricted support if both (*a*) the donor does not restrict the use of the assets contributed to the organization and (*b*) neither the agreement nor state law requires the assets received by the not-for-profit organization to be invested until the income beneficiary's death. If either of these situations exists, the contribution should be classified as restricted and should be reclassified if temporary restrictions or legal requirements are satisfied. If neither of these situations exist but state law imposes other limitations on the organization, such as limitations on the manner in which some net assets are invested, such limitations should be disclosed in the notes to the financial statements.

[12] Net income unitrusts are similar to pooled life-income funds, because the corpus is maintained. Accordingly, financial reporting for net income unitrusts is similar to reporting for pooled life-income funds.

the assets are received from the donor. The contribution should be measured at the fair value of the assets to be received, discounted for the estimated time period until the donor's death. The contributed assets should be recognized at fair value when received. The difference between the fair value of the assets when received and the revenue recognized should be recorded as deferred revenue, representing the amount of the discount for future interest.

6.37 Periodic income on the fund and payments to the donor should be reflected as increases and decreases in a liability to the donor. Amortization of the discount should be recognized as a reduction in the deferred revenue account and as a change in the value of split-interest agreements and reported as a change in temporarily restricted net assets. Upon the donor's death, any remaining balance in the deferred revenue account should be closed and a change in the value of split-interest agreements should be recognized. A reclassification to unrestricted net assets is also necessary to record the satisfaction of the time restriction on temporarily restricted net assets.

Auditing

6.38 Since for-profit organizations do not usually enter into split-interest agreements, the specific audit objectives, selected controls, and auditing procedures related to such agreements are unique to not-for-profit organizations and are presented below. See also the discussion concerning confirming receivables in paragraphs 5.68 and 5.69 of chapter 5 of this Guide.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Existence/ occurrence	Amounts recognized as (1) contribution revenues, (2) cash, investments, contributions receivable, and other assets held in trust under split-interest agreements, and (3) liabilities for amounts held for others resulting from split-interest agreements represent valid revenues, assets, and liabilities.	Management authorizes split-interest agreements.	Review split-interest agreements and correspondence with donors or trustees.
Completeness	All unconditional split-interest agreements are recognized. All income received under split-interest agreements is recorded.	Controls ensure that split-interest agreements are known and recorded. Management reviews income distribution terms of split-interest agreements and determines that periodic reports and remittances from trustees conform to those terms.	Review minutes of governing board and governing board committee meetings for evidence of split-interest agreements. Compare income distribution terms of split-interest agreements to periodic reports and remittances from trustees; trace periodic reports and remittances from trustees to cash receipts records.
Valuation	Assets and revenues recognized at the inception of	Documentation supports the determination of assets, liabilities,	Review documentation, including reports of actuaries,

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
	split-interest agreements are measured at fair value when received, and liabilities for amounts held for others are recognized at the present value of the payments expected to be made to other beneficiaries, using appropriate measurement methods.	revenues, and changes in the value of split-interest agreements, both at the inception of the agreements and over their term.	supporting the determination of fair value of assets and revenues and the present value of payments expected to be made to other beneficiaries at the inception of split-interest agreements and over their term; consider the need to apply provisions of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), in conjunction with auditing the actuarial calculations.
	Amortization of the discount associated with the contribution and revaluations of expected future payments to beneficiaries based on changes in actuarial assumptions are recognized during the term of split-interest agreements.		
Rights and obligations; presentation and disclosure	Restrictions on contributions arising from split-interest agreements have been met.	Split-interest agreements are reviewed for restrictions.	Review split-interest agreements and donor correspondence.
	Contribution revenues recognized under split-interest agreements are reported in the proper net asset class.		Determine that appropriate reclassifications are made on the statement of activities as assets are distributed to the organization or as

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
	Contribution revenues and changes in net assets from amortization of the discount associated with the contribution and revaluations of expected future payments to beneficiaries based on changes in actuarial assumptions that are recognized during the term of split-interest agreements are reported in the proper net asset class.		restrictions otherwise expire.
	Temporarily restricted net assets are reclassified as unrestricted net assets as assets are distributed to the not-for-profit organization or as restrictions otherwise expire.		

6.39

Appendix—Journal Entries

1. This appendix provides journal entries related to the examples in paragraphs 6.16 through 6.37.

2. ***Charitable Lead Trust (not-for-profit organization is trustee)*** (paragraphs 6.17 through 6.20)

Not-for-profit organization (NPO) A enters into an irrevocable charitable lead annuity trust arrangement with a donor whereby:

- The donor establishes a trust, with NPO A serving as trustee.
- The terms of the trust are that NPO A is to receive an annuity of $X per year until the donor's death.
- Distributions received from the trust by NPO A are unrestricted.
- Upon the death of the donor, the remaining balance in the trust passes to the donor's estate.

Solution:

Creation of the trust:

dr. Assets Held in Charitable Lead Trust

cr. Liability for Amounts Held for Others

cr. Contribution Revenue—Temporarily Restricted

(Assets measured at fair value when received; revenue measured at present value of cash flows to be received by NPO over the expected life of the donor)

Over the term of the trust:

dr. Assets Held in Charitable Lead Trust

cr. Liability for Amounts Held for Others

(Trust income and changes in fair value of assets held in trust, to the extent recognized)

dr. Cash

cr. Assets Held in Charitable Lead Trust

(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets—Reclassifications Out

cr. Unrestricted Net Assets—Reclassifications In

(Reclassification of amounts received by NPO)

dr. Liability for Amounts Held for Others

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and revaluation based on changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability for Amounts Held for Others

dr. Change in Value of Split-Interest Agreements—Temporarily Restricted (or cr.)

cr. Assets Held in Charitable Lead Trust

(Return of assets to donor's estate)

3. ***Charitable Lead Trust (NPO is not trustee)*** (paragraph 6.21)

The fact situation is the same as in the previous example except that the NPO is not the trustee.

Solution:

Creation of the trust:

dr. Contributions Receivable from Lead Trust

cr. Contribution Revenue—Temporarily Restricted

(Beneficial interest in trust assets measured at the present value of cash flows to be received by NPO over the expected life of the donor)

Over the term of the trust:

dr. Cash

cr. Contributions Receivable from Lead Trust

(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets—Reclassifications Out

cr. Unrestricted Net Assets—Reclassifications In

(Reclassification of amount received by NPO)

dr. Contributions Receivable from Lead Trust

cr. Change in Value of Split-Interest Agreements —Temporarily Restricted

(Amortization of discount and changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Change in Value of Split-Interest Agreements—Temporarily Restricted

cr. Contributions Receivable from Lead Trust

(Closeout receivable)

4. ***Perpetual Trust Held by a Third Party*** (paragraphs 6.22 through 6.24)

Donor enters into an irrevocable perpetual trust agreement with a third-party trustee with NPO B as the income beneficiary whereby:

- The donor establishes a trust, with its bank serving as trustee, with a payment to the trust to be invested in perpetuity by the trustee.
- The terms of the trust are that NPO B is to be the sole beneficiary and receive the income on the trust assets as earned in perpetuity with no restrictions on its use.

Solution:

Creation of the trust:

dr. Beneficial Interest in Perpetual Trust

cr. Contribution Revenue—Permanently Restricted

(Assets and revenue measured at present value based on the expected future cash flows to NPO [generally measured by the fair value of assets contributed to the trust, unless facts and circumstances indicate that the fair value of the assets contributed to the trust differs from the present value of the expected future cash flows])

Each period:

dr. Cash

cr. Investment Income (Unrestricted)

(Income received from trust [net asset class based on stipulations of the trust])

dr. Beneficial Interest in Perpetual Trust

cr. Gain or Loss—Permanently Restricted

(To adjust asset for changes in present value of expected cash flows—debit and credit could be reversed)

5. *Charitable Remainder Trust (NPO is trustee)* (paragraphs 6.25 through 6.28)

NPO C enters into a charitable remainder unitrust agreement with a donor whereby:

- A trust is established by the donor, to be administered by NPO C.
- The donor's spouse is to receive an annual distribution of X percent of the fair market value of the trust's assets each year until the spouse dies.
- At the time of death of the donor's spouse, the remaining assets of the trust are to be distributed to NPO C as permanent endowment.

Solution:

Creation of the trust:

dr. Assets Held in Charitable Remainder Trust

cr. Liability Under Unitrust Agreement

cr. Contribution Revenue—Permanently Restricted

(Assets measured at fair value when received; liability measured at the present value of expected future cash flows to be paid to the beneficiary)

Over the term of the trust:

dr. Assets Held in Charitable Remainder Trust

cr. Liability Under Unitrust Agreement

(Trust income and change in fair value of assets held in trust, to the extent recognized)

dr. Liability Under Unitrust Agreement

cr. Assets Held in Charitable Remainder Trust

(Payment to beneficiary)

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(Amortization of discount and adjustment of liability to reflect change in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(To close liability)

dr. Endowment Assets

cr. Assets Held in Charitable Remainder Trust

(To close trust and recognize assets as endowment)

6. ***Charitable Remainder Trust (NPO is not trustee)*** (paragraph 6.29)

The fact situation is the same as in the previous example, except that the NPO does not serve as trustee.

<u>Solution:</u>

Creation of the trust:

dr. Contributions Receivable from Remainder Trust

cr. Contribution Revenue—Permanently Restricted

(Beneficial interest measured at the present value of estimated future cash flows expected to be received by the NPO)

Over the term of the trust:

dr. Contributions Receivable from Remainder Trust

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(Amortization of discount and changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Endowment Assets

cr. Contributions Receivable from Remainder Trust

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(NPO receives distribution of trust assets from trustee, measured at fair value; the receivable account is closed and the change in value of split-interest agreements reflects the difference)

7. ***Charitable Gift Annuity*** (paragraphs 6.30 through 6.33)

NPO D enters into a charitable gift annuity contract with a donor whereby:

- Assets are transferred to NPO D and are available for unrestricted use by NPO D.
- NPO D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies, at which time the remaining assets are available for the unrestricted use of NPO D.

Solution:

Creation of the annuity:

dr. Assets

cr. Annuity Payment Liability

cr. Contribution Revenue—Unrestricted

(Assets measured at fair value when received, liabilities at the present value of expected future cash flows to be paid to the annuity beneficiary)

Over the term of the annuity:

dr. Annuity Payment Liability

cr. Cash

(Payment to annuity beneficiary)

dr. Change in Value of Split-Interest Agreements—Unrestricted

cr. Annuity Payment Liability

(Amortization of discount on liability and recording of any change in the life expectancy of the beneficiary—debit and credit could be reversed)

Termination of the annuity:

dr. Annuity Payment Liability

cr. Change in Value of Split-Interest Agreements—Unrestricted

(To close the annuity payment liability)

8. ***Pooled (Life) Income Fund*** (paragraphs 6.34 through 6.37)

NPO E forms, invests, and manages a pooled income (or life income) fund. The fund is divided into units, and contributions from many donors are pooled. Donors are assigned a specific number of units based on the proportion of the fair market value of the contribution to the total fair market value of the fund. A donor makes a contribution to the fund, is assigned a specific number of units, and will receive the actual income earned on those units until his or her death. The assets contributed must be invested in the fund until the donor's death. At that time, the value of the units assigned to the donor will revert to NPO E, and those assets will be available to NPO E without restriction.

Solution:

Contribution of assets:

dr. Assets of Pooled Income Fund

cr. Contribution Revenue—Temporarily Restricted

cr. Discount for Future Interest (Deferred Revenue)

(Assets recorded at fair value on date of receipt. Contribution revenue measured at the fair value of assets received, discounted for a term equal to the life expectancy of the donor.)

Over the term of the agreement:

dr. Assets of Pooled Income Fund

cr. Liability to Life Beneficiary

(Income earned on units assigned to donor)

dr. Liability to Life Beneficiary
cr. Assets of Pooled Income Fund
(Payment to life beneficiary)

dr. Discount for Future Interest (Deferred Revenue)
cr. Change in Value of Split-Interest Agreements—Temporarily Restricted
(Amortization of discount and changes in the life expectancy of the beneficiary)

Termination of the agreement:

dr. Discount for Future Interest (Deferred Revenue)
cr. Change in Value of Split-Interest Agreement—Unrestricted
(To close discount upon the death of the life beneficiary)

dr. Cash or Investment Assets
cr. Assets of Pooled Income Fund
(To recognize assets available for use upon the death of the life beneficiary)

dr. Temporarily Restricted Net Assets—Reclassification Out
cr. Unrestricted Net Assets—Reclassification In
(Reclassification based on the expiration of the time restriction)

Chapter 7

Other Assets

Introduction

7.01 Some assets held by not-for-profit organizations are similar to those held by for-profit entities. This chapter considers assets that are not discussed elsewhere in this Audit and Accounting Guide (Guide) and that present accounting issues unique to not-for-profit organizations.

Inventory

7.02 Not-for-profit organizations may acquire merchandise inventory for resale; for example, items held for sale by a bookstore, dining service, kitchen, or thrift shop. Merchandise inventory may be acquired by not-for-profit organizations in exchange transactions or from contributions. (Paragraphs 5.10 through 5.19 and chapter 12, "Revenues and Receivables From Exchange Transactions," of this Guide, discuss exchange transactions.)

7.03 Contributions of inventory should be reported in the period received and should be measured at fair value. Estimates of fair value may be obtained from published catalogs, vendors, independent appraisals, estimated selling prices, and other sources. If methods such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (*a*) used internally by the not-for-profit organization or for program purposes or (*b*) sold by the organization, the item received should not be recognized. (Paragraphs 5.07 through 5.09 of this Guide discuss gifts in kind.)

Prepaid Expenses, Deferred Charges, and Similar Costs

7.04 Not-for-profit organizations may incur costs that relate to future rather than to current-period activities. Except as discussed elsewhere in this chapter, the recognition and measurement principles for those costs are similar to those used by business organizations. Accordingly, amounts expended for prepaid expenses and deposits should be reported as assets. (In conformity with Statement of Position [SOP] 93-7, *Reporting on Advertising Costs*, advertising costs should not be capitalized unless they are costs of direct-response advertising that is expected to result in future benefits, such as gift shop sales.)

Collections

7.05 Appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines *collections* as follows:

> Works of art, historical treasures, or similar assets that are (*a*) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (*b*) protected, kept unencumbered, cared for, and preserved, and (*c*) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

7.06 Accounting for collections depends on whether an organization adopts a policy of recognizing collections as assets. When organizations initially adopt FASB Statement No. 116, they may choose to (*a*) capitalize their collections, including all items acquired in prior periods that have not been previously capitalized and all items acquired in future periods (that is, *retroactive capitalization*); (*b*) capitalize only those items acquired after initial adoption of FASB Statement No. 116 (that is, *prospective capitalization*); or (*c*) capitalize no collections. Capitalization of part of the collections (that is, *selective capitalization*) is prohibited.[1]

7.07 If an organization adopts a policy of capitalizing collections, items acquired in exchange transactions should be recognized as assets in the period in which they are acquired and should be measured at cost. Contributed collection items should be recognized as assets and as contributions in the appropriate net asset class[2] and should be measured at fair value. Fair value can be best measured by the quoted market price of the contributed item. If such prices are not available, quoted market prices for similar items, appraised values, and other techniques may be used to estimate fair value.[3] Major uncertainties about the future service potential or economic benefit of contributed collection items, for example, items acquired for scientific or educational research having no alternative future uses, may indicate that they should not be recognized.

7.08 If an organization adopts a policy of not capitalizing collections, no assets or contributions should be recognized from the acquisition of collection items. Cash flows from purchases, sales, and insurance recoveries of unrecognized, noncapitalized collection items should be reported as investing activities on the statement of cash flows. Additional disclosures described in paragraphs 7.12 and 7.13 should be made if an organization elects not to capitalize collections.

7.09 Contributions made by not-for-profit organizations of previously recognized collection items should be reported as expenses and decreases in assets in the period in which the contributions are made, and should be measured at fair value. (A gain or loss should be recognized on contributions made of previously recognized collection items if their fair value differs from their carrying amount.) Contributions made by not-for-profit organizations of previously unrecognized collection items should not be recognized on the face of the financial statements; disclosure of those contributions should be made in notes to the financial statements.

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[1] Initial adoption of FASB Statement No. 116 may be reported by (*a*) retroactive restatement of opening net assets for the earliest year presented or, if no prior years are presented, for the year in which the Statement is first applied, or (*b*) reporting the effect as a change in accounting principle in conformity with paragraph 19 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

[2] Contributions should be classified as increases in unrestricted, temporarily restricted, or permanently restricted net assets, depending on the existence and type of restrictions imposed by donors. Chapter 5, "Contributions Received and Agency Transactions," of this Guide, provides guidance concerning accounting for contributions with donor-imposed restrictions.

[3] For practical reasons, items that are retroactively capitalized on initial application of FASB Statement No. 116 can be recognized at their (*a*) cost or fair value at the date of acquisition or (*b*) cost or current market value at the date of initial recognition.

7.10 Works of art, historical treasures, and similar assets that are not collection items should be recognized as assets. Items acquired in exchange transactions should be measured at cost. Contributions of those items should be measured at fair value at the date of contribution and should be recognized in a statement of activities as support that increases the appropriate net asset classes.

Financial Statement Presentation

7.11 If an organization adopts a policy of retroactively or prospectively capitalizing collections that meet the definition in FASB Statement No. 116, a statement of financial position should include the total amount capitalized on a separate line item, "Collections" or "Collection Items." The amount capitalized for works of art, historical treasures, and similar assets that do not meet the definition should be disclosed separately on the face of the statement of financial position or in the notes.

7.12 A not-for-profit organization that does not recognize and capitalize its collections should report the following on the face of its statement of activities, separately from revenues, expenses, gains, and losses:[4]

- Costs of collection items purchased as a decrease in the appropriate class of net assets
- Proceeds from sale of collection items as an increase in the appropriate class of net assets
- Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets.

Similarly, an entity that capitalizes its collections prospectively should report proceeds from sales and insurance recoveries of items not previously capitalized separately from revenues, expenses, gains, and losses.

7.13 A not-for-profit organization that does not recognize and capitalize its collections or that capitalizes collections prospectively should describe its collections, including their relative significance, and its accounting and stewardship policies for collections. If collection items not capitalized are deaccessed during that period, it also should (*a*) describe the items given away, damaged, destroyed, lost, or otherwise deaccessed during the period or (*b*) disclose their fair value. In addition, a line item should be shown on the face of the statement of financial position that refers to the disclosures required by this paragraph. That line item should be dated if collections are capitalized prospectively, for example, "Collections acquired since January 1, 19X1 (Note X)."

Illustrative Disclosures

7.14 This section provides examples of notes to the financial statements that illustrate some of the financial statement disclosures concerning collection items.

Example 1—Organizations That Capitalized Collections Prior to FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

The organization has capitalized its collections since its inception. If purchased, items accessioned into the collection are capitalized at cost, and if do-

[4] Paragraph 141 of FASB Statement No. 116 illustrates these disclosures.

nated, they are capitalized at their appraised or fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees). Gains or losses on the deaccession of collection items are classified on the statement of activities as unrestricted or temporarily restricted support depending on donor restrictions, if any, placed on the item at the time of accession.

Example 2—Organizations That Capitalize Collections Retroactively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

In 19X1, the organization capitalized its collections retroactively in conformity with FASB Statement No. 116. To the extent that reliable records were available, the organization capitalized collection items acquired prior to 19X1 at their cost at the date of purchase or, if the items were contributed, at their fair or appraised value at the accession date (the date on which the item was accepted by the Acquisitions Committee of the Board of Trustees). Other collection items, particularly those acquired prior to 19X1 when detailed curatorial records began to be maintained, have been capitalized at their appraised or estimated current market value. In some cases, collection items held solely for their potential educational value or historical significance were determined to have no alternative use and were not assigned values for the purpose of capitalization. The collection items capitalized retroactively were determined to have a total value of $11,138,100. This amount is reflected as a change in accounting principle on the statement of activities.

Example 3—Organizations That Capitalize Their Collections Prospectively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

Collection items acquired on or after July 1, 19X0: Accessions of these collection items are capitalized at cost, if the items were purchased, or at their appraised or fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees), if the items were contributed. Gains or losses from deaccessions of these items are reflected on the statement of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Collection items acquired prior to July 1, 19X0: Collection items accessioned prior to July 1, 19X0 were recorded as decreases in unrestricted net assets, if the items were purchased. No financial statement recognition was made for contributed collection items. Proceeds from insurance recoveries or deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Note Y: Accounting Change

In 19X1, the organization adopted FASB Statement No. 116. The organization has determined that the cost to capitalize its collections retroactively would be excessive because records of the cost of purchased items and of the fair value at the date of contribution of donated items are unreliable or do not exist. However, such information is available for current-year acquisitions and will be maintained on an ongoing basis. Therefore, the organization has elected to capitalize prospectively all collection items acquired after July 1, 19X0, the date of initial adoption of FASB Statement No. 116.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects. Each of the items is cataloged for educational, research, scientific, and curatorial purposes, and activities verifying their existence and assessing their condition are performed continuously.

During 19X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. Because those items were purchased prior to July 1, 19X0, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in unrestricted net assets on the statement of activities. No other collection items were deaccessioned in 19X1 or 19X0.

Example 4—Organizations That Do Not Capitalize Collections

Note X: Summary of Significant Accounting Policies

The collections, which were acquired through purchases and contributions since the organization's inception, are not recognized as assets on the statement of financial position. Purchases of collection items are recorded as decreases in unrestricted net assets in the year in which the items are acquired, or as temporarily or permanently restricted net assets if the assets used to purchase the items are restricted by donors. Contributed collection items are not reflected on the financial statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects that are held for educational, research, scientific, and curatorial purposes. Each of the items is cataloged, preserved, and cared for, and activities verifying their existence and assessing their condition are performed continuously. The collections are subject to a policy that requires proceeds from their sales to be used to acquire other items for collections.

During 19X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. These artifacts were contributed in 19XX, with a restriction that limited any future proceeds from deaccessions to acquisitions of artifacts from a similar period. As a result, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in temporarily restricted net assets on the statement of activities. No other collection items were deaccessioned in 19X1 or 19X0.

Auditing

7.15 Many audit objectives, controls, and auditing procedures for other assets of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

Inventory

7.16 As discussed in paragraph 7.03, in certain circumstances, the fair value of contributed inventory may be measured using methods such as estimates, averages, or computational approximations. Such methods may be used in connection with the financial statement assertion of valuation. However, such methods are unrelated to the assertions of existence and occurrence. Auditors should be mindful of the provisions of Statement on Auditing Standards (SAS) No. 1, section 331, *Inventories* (AICPA, *Professional Standards,* vol. 1, AU sec. 331), which provides guidelines concerning inventory observation.

Collection Items

7.17 Examples of auditing procedures that might be applied for collection items are presented in the table at the end of this chapter. If collection items are not capitalized, the auditor should perform procedures to understand the organization's controls over recording accessions (including contributions) and deaccessions of collection items, controlling the collections, and periodically physically inspecting them. Those auditing procedures are performed, in part, to provide evidence supporting the disclosures required by paragraph 27 of FASB Statement No. 116. They are also part of the auditor's work in obtaining an understanding of the organization's controls over collection items and contributions of such items. The objective of performing those procedures when the collection is not recognized is not to obtain evidence to corroborate a recorded amount, since no amount has been recorded. Instead, the objective is to help the auditor understand the organization's control environment, which is a component of its internal control.

7.18 As noted in chapter 2, "General Auditing Considerations," of this Guide, SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires the auditor to understand the organization's control environment, an important part of which is management's philosophy and operating style and its integrity and ethics. Management's philosophy and operating style include management's approach to taking and monitoring business risks and its attitudes and actions toward financial reporting. Management's integrity and ethics include the emphasis management places on meeting budget, profit, and other financial and operating goals. The auditor needs to know about the control environment to be able to assess control risk as it relates to the various segments of the audit, because the control environment often has pervasive effects on how the auditor plans the entire audit, including those parts that are unrelated to collections and changes in them.

7.19 The necessary understanding of the control environment does not include a requirement to test controls that are part of the control environment (or any other controls, for that matter), but merely to obtain knowledge about the design of relevant policies, procedures, and records, and whether they have been placed in operation by the entity. What is sometimes referred to as a *transaction review* or *walk-through* of relevant custodial controls would probably be adequate for the auditor to gain the requisite level of knowledge about controls over the collection as part of understanding the control environment.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Noncapitalized Collection Items			
Valuation	Noncapitalized works of art, historical treasures, and similar assets meet the definition of "collections" in FASB Statement No. 116.	Policies and procedures for determining that noncapitalized assets are "collections."	Review policies and procedures determining the appropriateness of classifying assets as noncapitalized collections.
Presentation and Disclosures	Transactions involving noncapitalized collection items are appropriately displayed in the statement of activities and the statement of cash flows.		Determine the appropriateness of display and disclosures related to noncapitalized collections.
	Appropriate disclosures referenced in a line item on the face of the statement of financial position, meet the requirements of FASB Statement No. 116.		
Existence/ occurrence	Collection items exist.	Procedures for controlling collections and periodically physically inspecting them.	Review the organization's procedures for controlling collections and physically inspecting them.
	Collection items acquired in the current period by purchase and contribution were authorized.	Controls ensure that purchased collection items are authorized, contributed	Consider whether to observe the physical inspection.
	Deaccessions from collections		

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
	occurred and were authorized.	collection items are appropriately accessioned, and deaccessions are authorized.	Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records.
			Review documentation supporting accessions and deaccessions of collection items.
			Review minutes of governing board and governing board committee meetings for authorization of major accessions and deaccessions.
			Make inquiries of curatorial personnel about deaccessioned collection items.
Rights and obligations	Restrictions on contributed collection items have been met.	Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the presence or absence of restrictions.
			Review minutes of governing board and governing board committee meetings for evidence of restrictions.
			If specific collection items

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
			are restricted, review collection item transactions for propriety of use and disposition.
Capitalized Collection Items (Excluding Matters Related to Retroactive Capitalization)			
Existence/ occurrence	Collection items exist. Collection items acquired in the current period by purchase and contribution were authorized. Deaccessions from collections occurred and were authorized.	Procedures for controlling collections and periodically physically inspecting them. Controls ensure that purchased collection items are authorized, contributed collection items are appropriately accessioned, and deaccessions are authorized.	Review the organization's procedures for controlling collections and physically inspecting them. Consider whether to observe the physical inspection. Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records. Review documentation supporting accessions and deaccessions of collection items. Review minutes of governing board and governing board committee meetings for authorization of major accessions and deaccessions. Make inquiries of curatorial personnel about

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
			deaccessioned collection items.
Completeness; valuation	All collection items acquired in exchange transactions are recognized as assets at cost. All contributed collection items are recognized as assets and as contributions at fair value.	Controls exist to ensure that all purchases and contributions of collection items are recognized as assets (at cost and fair value, respectively) and that contribution revenues are recognized for contributed collection items.	Review minutes of governing board and governing board committee meetings for evidence of current period purchases and contributions. Review documentation and procedures supporting the determination of cost or fair value.
Rights and obligations	Restrictions on contributed collection items have been met.	Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the presence or absence of restrictions. Review minutes of governing board and governing board committee meetings for evidence of restrictions. If specific collection items are restricted, review collection item transactions for propriety of use and disposition.
Presentation and disclosure	Contributed and deaccessioned collection items are reported in the appropriate net asset class.		Review documentation underlying collection items for propriety of classification.

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Retroactive Capitalization of Collection Items			
Existence/ occurrence; completeness; valuation; rights and obligations; presentation and disclosure	Retroactively capitalized collection items exist, are the property of the organization, are properly valued, and are reported in the appropriate net asset class; all collection items owned by the organization are capitalized.	Procedures for controlling collections and determining their cost or fair value at date of acquisition or their current cost or current market value at date of initial recognition.	Review documents and procedures supporting the determination of cost or fair value at date of acquisition or current cost or current market value at date of initial recognition. Review donor correspondence to determine the presence or absence of restrictions. Review minutes of governing board and governing board committee meetings for evidence of restrictions. Review documentation underlying contributed collection items for propriety of classification. Consider the need to apply provisions of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), in conjunction with determining the reliability of carrying values.

Chapter 8

Investments[1]

Introduction

8.01 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, provides measurement guidance for investments in equity securities with readily determinable fair values and all investments in debt securities, as well as reporting standards for all investments held by not-for-profit organizations, subject to the exceptions in the following sentence.[2] FASB Statement No. 124 does not apply to investments in equity securities that are accounted for under the equity method or to investments in consolidated subsidiaries.

8.02 FASB Statement No. 124 does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value and all investments in debt securities. Investments not covered by FASB Statement No. 124 are referred to in this Audit and Accounting Guide (Guide) as *other investments*. Other investments include, among others, investments in real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, and equity securities that do not have a readily determinable fair value. The various AICPA Industry Audit Guides, Audit and Accounting Guides, and Statements of Position (SOP) that are superseded by this Guide included guidance concerning other investments. This Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that are superseded by this Guide, until such time as the FASB or the Accounting Standards Executive Committee (AcSEC) issues more definitive guidance.[3] Accordingly, this chapter provides no new measurement guidance on accounting for other investments. Instead, it incorporates the measurement guidance for other investments currently found in the various AICPA publications that are superseded by this Guide, except as stated in the next sentence. To the extent that the guidance in the AICPA publications that are superseded by this Guide requires all investments to be measured using the same measurement attribute, only other investments, rather than all investments, are required to be measured using the same measurement attribute. For example, if an AICPA publication that is superseded by this Guide permits investments to be carried at either cost or fair value, provided that the same attribute is used for all investments, and if equity securities with a readily determinable fair value are carried at fair value in conformity with the guidance in FASB Statement No. 124, other investments are permitted to be carried at either cost or fair value, provided that the same attribute is used for all other investments.

8.03 Not-for-profit organizations acquire various kinds of investments by contribution or purchase. This chapter discusses the accounting recognition,

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[1] Cash held temporarily by a custodian for investment purposes may be included as part of investments on a statement of financial position rather than as cash.

[2] FASB Statement No. 124 is effective for annual financial statements issued for fiscal years beginning after December 15, 1995. Earlier application is encouraged.

[3] Appendix A [paragraph 8.28] of this chapter summarizes the measurement guidance for other investments.

measurement, and disclosure requirements for investments in (*a*) equity securities with a readily determinable fair value not accounted for under the equity method and not required to be consolidated, (*b*) debt securities, and (*c*) other investments. Split-interest gifts, including investments held by others, are discussed in chapter 6, "Split-Interest Agreements," of this Guide.

8.04 SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which is included as appendix B [paragraph 8.29] of this chapter, was issued in September 1994. The FASB is also studying the concept of a reporting entity and issues related to consolidations, the application of the equity method of accounting, and accounting for various types of joint ventures.[4] Accordingly, those matters are not covered by this Guide.

8.05 For all investments except investments in equity securities that are accounted for under the equity method and investments in consolidated subsidiaries, this chapter provides accounting and auditing guidance concerning the initial recognition and measurement, investment income, the measurement attributes used for subsequent valuation, unrealized and realized gains and losses, and financial statement display and disclosure. Many of the requirements under generally accepted accounting principles in these areas are the same as those for for-profit entities; accordingly, this chapter focuses on those issues that are unique to not-for-profit organizations.

Initial Recognition

8.06 Investments are initially recorded at their acquisition cost (including brokerage and other transaction fees) if they were purchased and at fair value if they were received as a contribution or through an agency transaction.[5] Chapter 5, "Contributions Received and Agency Transactions," of this Guide, includes guidance concerning distinguishing contributions from agency transactions and discusses the classification of contributions.

Investment Income

8.07 Investment income includes dividends, interest, rents, royalties, and similar payments and should be recognized as earned. The revenue (often referred to as income) should be reported as an increase in unrestricted, temporarily restricted, or permanently restricted net assets, depending on donor stipulations on the use of the income.[6] For example, if there are no donor-imposed restrictions on the use of the income, it should be reported as an increase in unrestricted net assets. On the other hand, a donor may stipulate that a gift be invested in perpetuity, with the income to be used to support a specified program. The initial gift creates permanently restricted net assets; the investment income is temporarily restricted for support of the donor-

[4] On October 16, 1995, the FASB released an exposure draft of a proposed Statement of Financial Accounting Standards, *Consolidated Financial Statements: Policy and Procedures*.

[5] Guidance in this chapter concerning the classification of investment income, unrealized gains and losses, and realized gains and losses applies to investments other than investments held by a not-for-profit organization as an agent. If a not-for-profit organization is holding an investment as an agent and has little or no discretion in determining how the investment income, unrealized gains and losses, and realized gains and losses resulting from those investments will be used, those investment activities should be reported as agency transactions and, therefore, as changes in assets and liabilities, rather than as changes in net assets.

[6] Paragraph 8.17 discusses an alternative accounting policy for circumstances in which temporary restrictions on investment income are met in the same reporting period as the income is recognized.

specified program. If the restrictions on the income are met, the statement of activities should report a reclassification from temporarily restricted net assets to unrestricted net assets.

8.08 FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities should report the gross amounts of revenues and expenses. It also notes, however, that "investment revenues may be reported net of related expenses, such as custodial fees and investment advisory fees, provided that the amount of the expenses is disclosed either in the statement of activities or in notes to financial statements" (paragraph 24 of FASB Statement No. 117). Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses investment expenses.

Valuation Subsequent to Acquisition

8.09 FASB Statement No. 124 provides that investments in equity securities with readily determinable fair value and all debt securities should be reported at their fair value. As noted in paragraph 8.02, AICPA guidance concerning the carrying amounts of other investments subsequent to acquisition is diverse. Organizations should follow the guidance in appendix A [paragraph 8.28] of this chapter for their other investments. That guidance is based on the AICPA Industry Audit Guides, Audit and Accounting Guides, and SOPs that are superseded by this Guide, and is intended to maintain the status quo for other investments held by each kind of not-for-profit organization covered by that literature until it is changed by the FASB or by AcSEC.

Unrealized and Realized Gains and Losses

8.10 Unrealized gains and losses arise from changes in the fair value of investments, exclusive of dividend and interest income recognized but not yet received and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized gains and losses are recognized in some circumstances (for example, when the investments are carried at fair value), but not in others (for example, when the investments are carried at cost). To the extent that unrealized gains and losses are recognized, they should be reported in the statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by donors to a specified purpose or future period.[7]

8.11 Realized gains and losses arise from selling or otherwise disposing of investments. Realized gains and losses should be reported in the statement of activities as changes in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor-imposed stipulations or by law.[8] (Paragraph 8.10 discusses unrealized gains and losses. If realized gains and losses arise from selling or otherwise disposing of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amount reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should exclude the amount that has previously been recognized in the statement of activities. However, the components of that gain or loss may be reported as the

[7] Paragraph 8.17 discusses an alternative accounting policy for circumstances in which temporary restrictions on gains are met in the same reporting period as the gains are recognized.

[8] See footnote 7.

realized amount (the difference between amortized cost and the sales proceeds) and the unrealized amount recognized in prior reporting periods. Table 8.1 below illustrates this reporting.)

Table 8.1

Facts

1.	In 19X1, a not-for-profit organization with a December 31 year end purchases an equity security with a readily determinable fair value for $5,000.
2.	At December 31, 19X1, the fair value of the security is $7,000.
3.	During 19X2, the security is sold for $11,000.

Reporting Gains and Losses

19X1	Recognize a $2,000 gain and adjust the carrying value to $7,000. (The reported gain equals $7,000 fair value less $5,000 carrying value.)
19X2	Recognize a $4,000 gain and adjust the carrying value to zero. (The gain may be reported as the net of $11,000 selling price less the $7,000 carrying value at the time the security was sold. Alternatively, the gain may be displayed as the realized gain of $6,000 [$11,000 selling price less $5,000 cost] less the $2,000 unrealized gain previously recognized.)

Investment Pools

8.12 A not-for-profit organization may pool part or all of its investments (including investments arising from contributions with different kinds of restrictions) for portfolio management purposes. The number and the nature of the pools may vary from organization to organization.

8.13 When a pool is established, ownership interests are initially assigned (typically through unitization) to the various pool categories (sometimes referred to as *participants*) based on the market value of the cash and securities placed in the pool by each participant. Current market value is used to determine the number of units allocated to additional assets placed in the pool and to value withdrawals from the pool. Investment income and realized gains and losses (and any recognized unrealized gains and losses) are allocated equitably based on the number of units assigned to each participant.

Donor-Restricted Endowment Funds

8.14 A donor's stipulation that requires a gift to be invested in perpetuity or for a specified term creates a donor-restricted endowment fund. Donors or relevant law may require a not-for-profit organization to retain permanently some portion of gains and losses (net appreciation) on donor-restricted endowment funds. Unless net appreciation on donor-restricted endowment funds is temporarily or permanently restricted by a donor's explicit stipulation or by a law that extends a donor's restriction to them, net appreciation on donor-restricted endowment funds should be reported as a change in unrestricted net assets.[9] Paragraph 11 of FASB Statement No. 124 notes that "...if a donor allows the organization to choose suitable investments, the gains are not permanently restricted unless the donor or the law requires that an amount be retained permanently. Instead, those gains are unrestricted if the investment income is unrestricted or are temporarily restricted if the investment income is temporarily restricted by the donor." Accordingly, in the absence of donor stipulations or law to the contrary, donor restrictions on the use of income of an endowment fund also extend to the net appreciation on the endowment fund.

8.15 Classification of recognized gains and losses should be based on the underlying facts and circumstances. If limitations exist that preclude the use of net gains on permanently restricted net assets, either as a result of explicit or clear implicit donor stipulations or by the law of the relevant jurisdiction, the net gains are permanently restricted. Paragraph 125 of FASB Statement No. 117 notes that "because donor stipulations and laws vary, not-for-profit organizations must assess the relevant facts and circumstances for their endowment gifts and their relevant laws to determine if net appreciation on endowments is available for spending or is permanently restricted."

8.16 Paragraphs 12 and 13 of FASB Statement No. 124 provide the following:

> 12. In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before a loss occurs. Any remaining loss shall reduce unrestricted net assets.
>
> 13. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, [footnote omitted] gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.

(After the fair value of the assets of the endowment fund equals the required level, gains that are restricted by the donor should be classified as increases in temporarily restricted net assets or permanently restricted net assets, depending on the donor's restrictions on the endowment fund.)

Financial Statement Presentation

8.17 Gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in unrestricted net assets if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the organization has a similar policy for reporting contributions received,[10] reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

8.18 Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.

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[9] Legal limitations that require the governing board to act to appropriate net appreciation for expenditure under a statutorily prescribed standard of ordinary business care and prudence do not extend donor restrictions to the net appreciation. Accordingly, unless the donor has explicitly restricted the net appreciation on an endowment fund, net appreciation subject to such limitations should be reported as a change in unrestricted net assets.

[10] Paragraph 5.30 discusses the accounting policy for reporting contributions received if the organization meets donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period as the contribution is received.

8.19 Some not-for-profit organizations manage their investments on a total return basis. Under the total return concept, organizations focus on the overall return on their investments, including both investment income and net appreciation. They then use a spending-rate formula to determine how much of that return will be used for current operations.

8.20 Under FASB Statement No. 117, however, all investment income and recognized gains and losses must be reported on the statement of activities and classified as unrestricted unless restricted by the donor or applicable law. Organizations are permitted to provide information on the face of the statement of activities and the notes to the financial statements about the total return on investments by segregating the total return between operating and non-operating components based on a spending-rate formula. If investment return reported in the statement of activities is separated into operating and nonoperating, certain information, as discussed in paragraph 8.23 of this Guide, is required to be disclosed. Those disclosures are illustrated in paragraphs 100 through 106 of FASB Statement No. 124.

8.21 FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement Nos. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and 107, *Disclosures about Fair Value of Financial Instruments*.

8.22 FASB Statement No. 119 requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

8.23 For each period for which a statement of activities is presented, a not-for-profit organization should disclose:

a. The composition of investment return including, at a minimum, investment income, net realized gains or losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value

b. A reconciliation of investment return to amounts reported in the statement of activities if investment return is separated into operating and nonoperating amounts, together with a description of the policy used to determine the amount that is included in the measure of operations and a discussion of circumstances leading to a change, if any, in that policy

8.24 For each period for which a statement of financial position is presented, a not-for-profit organization should disclose:

a. The aggregate carrying amount of investments by major types, for example, equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, oil and gas properties and real estate

b. The basis for determining the carrying amount for investments other than equity securities with readily determinable fair values and all debt securities

c. The method(s) and significant assumptions used to estimate the fair values of investments other than financial instruments[11] if those other investments are reported at fair value

d. The aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.

8.25 For the most recent period for which a statement of financial position is presented, a not-for-profit organization should disclose the nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk.[12]

Auditing

8.26 Many audit objectives, controls, and auditing procedures for investments of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

Net Appreciation on Endowment Funds

8.27 As discussed in this chapter, net appreciation on donor-restricted endowment funds should be reported as a change in unrestricted net assets unless the appreciation is temporarily or permanently restricted by explicit donor-imposed stipulations or by law. Laws concerning net appreciation of donor-restricted endowment funds may vary from jurisdiction to jurisdiction. For example, some jurisdictions follow trust law, some follow the Uniform Management of Institutional Funds Act (UMIFA), some follow modifications of UMIFA, and some follow interpretations of those laws issued by state Attorneys General. Generally, in jurisdictions following trust law, net appreciation is not spendable and therefore should be added to permanently restricted net assets. Also, it has generally been interpreted that, absent donor restrictions, net appreciation is spendable under UMIFA and therefore should be added to unrestricted net assets. Auditors should obtain an understanding about these issues and the laws concerning net appreciation on donor-restricted endowment funds applicable to the reporting organization.[13] Also, auditors should obtain representations from management about any interpretations made by the organization's governing board concerning whether laws

[11] Paragraph 10 of FASB Statement No. 107 requires organizations to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, amends FASB Statement No. 107 to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for certain nonpublic entities.

[12] Paragraph 20 of FASB Statement No. 105 requires organizations to disclose all significant concentrations of credit risk arising from financial instruments, whether from an individual counterparty or groups of counterparties.

[13] Auditors may find information available from State Societies of Certified Public Accountants, state Attorneys General, and industry publications useful in obtaining an understanding of these issues.

limit the amount of net appreciation of donor-restricted endowment funds that may be spent. However, for organizations operating in jurisdictions in which there may be questions concerning interpretations of the applicable laws or in which there are conflicting interpretations by various legal counsel, auditors should request the organization to obtain a specific opinion from legal counsel concerning interpretation of the legal requirements. (SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance concerning circumstances in which the auditor relies on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).)

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Contributed Investments, Investment Income, Gains, and Losses			
Rights and obligations; presentation and disclosure	Restrictions on contributed investments have been met. Restrictions on investment income, net realized gains, and net recognized unrealized gains that are imposed by donors or by law have been met. Investments and related income, gains, and losses are reported in the appropriate net asset class.	Contributions of investments and investment income, gains, and losses are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the existence of restrictions on, and classification of, investments and related income, gains, and losses. Review minutes of governing board and governing board committee meetings for evidence of donor or statutory restrictions on, and classification of, investments and related income, gains, and losses. If specific investments are restricted, review investment transactions for the propriety of dispositions.
Reclassification of Restricted Net Assets			
Presentation and disclosure	Restricted net assets are reclassified as unrestricted net assets in the statement of activities when restrictions are met on investment income restricted for support of donor-specified programs.		Determine that appropriate reclassifications are made in the statement of activities when restrictions are met on investment income restricted for donor-specified programs.

8.28

Appendix A—Measuring Other Investments

1. Other investments of institutions of higher education, including colleges, universities, and community or junior colleges, that were acquired by purchase may be reported at cost, and contributed other investments may be reported at their fair market value or appraised value at the date of the gift, unless there has been an impairment of value that is not considered to be temporary. Other investments may also be reported at current market value or fair value, provided that the same attribute is used for all other investments. (Investments in wasting assets are usually reported net of an allowance for depreciation or depletion.) The financial statements or notes should set forth the total performance (that is, investment income and realized and unrealized gains and losses) of the other investment portfolio.

2. Voluntary health and welfare organizations should report other investments at cost if purchased and at fair market value at the date of the contribution if contributed. If the market value of the other investments portfolio is below the recorded amount, it may be necessary to reduce the carrying amount of the portfolio to market or to provide an allowance for decline in market value. If it can reasonably be expected that the organization will suffer a loss on the disposition of an investment, a provision for the loss should be made in the period in which the decline in value occurs. Carrying other investments at market value is also acceptable. The same measurement attribute should be used for all other investments and should be disclosed.

3. Not-for-profit organizations that are not colleges, universities, or voluntary health and welfare organizations (that is, those that were included in the scope of the Audit and Accounting Guide *Audits of Certain Nonprofit Organizations,* and Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*) should report other investments at either fair value or the lower of cost or fair value. The same measurement attribute should be used for all other investments. Declines in investments carried at the lower of cost or market value should be recognized when their aggregate market value is less than their carrying amount; recoveries of aggregate market value in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost.

8.29

Appendix B

Statement of Position 94-3

Reporting of Related Entities by Not-for-Profit Organizations

September 2, 1994

Amendment to
AICPA Industry Audit Guides
Audits of Voluntary Health and Welfare Organizations
and *Audits of Colleges and Universities,*
AICPA Audit and Accounting Guide
Audits of Certain Nonprofit Organizations,
and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Prepared by the
Not-for-Profit Organizations Committee
Accounting Standards Division

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

In August 1996, the AICPA issued an Audit and Accounting Guide *Not-for-Profit Organizations* (the New Guide) which superseded the following AICPA Audit and Accounting Guides:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also superseded the following AICPA Statements of Position (SOPs):

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

The New Guide is effective for financial statements for fiscal years ending on or after December 31, 1996. Earlier application is permitted.

This SOP applies to entities following the New Guide.

Readers should note the following matters:

- In July 1996, the AICPA issued an Audit and Accounting Guide *Health Care Organizations* that superseded the Audit and Accounting Guide *Audits of Providers of Health Care Services*. This SOP does not apply to entities following *Health Care Organizations*, just as it did not apply to entities following *Audits of Providers of Health Care Services*.
- References to pronouncements and guidance that are superseded have been shaded.
- In applying the guidance in paragraph 7, readers should refer to chapter 8, "Investments," of the New Guide. Not-for-profit organizations that choose to report investments at market value in conformity with the New Guide may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.
- Although the New Guide superseded SOP 78-10, it did not supersede the guidance in paragraph 13 of this SOP that "[e]ntities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so." Organizations that presented consolidated financial statements in conformity with the guidance in SOP 78-10 may continue to do so.
- In applying the definition of "economic interest" in the Glossary, readers should refer also to paragraph 3.23 of the New Guide.

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SUMMARY

This statement of position (SOP) amends and makes uniform the guidance concerning reporting related entities in the following AICPA publications:

- Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

The conclusions in this SOP are based on the premise that (1) whether the financial statements of a reporting not-for-profit organization and those of one or more other not-for-profit or for-profit entities should be consolidated and (2) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

The guidance in this SOP focuses on (1) investments in for-profit entities and (2) financially interrelated not-for-profit organizations. That guidance includes the following:

Investments in For-Profit Entities

- A reporting not-for-profit organization should consolidate a for-profit entity in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest if the guidance in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires consolidation. The manner in which the for-profit entity's financial position, results of operations, and cash flows are presented in the reporting organization's financial statements depends on the nature of the activities of the for-profit entity.
- A reporting not-for-profit organization should use the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to report investments in common stock of a for-profit entity if the guidance in that Opinion requires the use of the equity method.
- Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.

Financially Interrelated Not-for-Profit Organizations

- A not-for-profit organization should consolidate another not-for-profit organization in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.
- A not-for-profit organization should consolidate another not-for-profit organization if the reporting not-for-profit organization has both control of the other not-for-profit organization, as evidenced by either ma-

jority ownership or a majority voting interest in the board of the other not-for-profit organization, and an economic interest in the other not-for-profit organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.

- A not-for-profit organization may exercise control of another not-for-profit organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization. In such circumstances, the not-for-profit organization is permitted, but not required, to consolidate the other not-for-profit organization, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If a not-for-profit organization controls another organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization and consolidated financial statements are not presented, the not-for-profit organization should make the financial statement disclosures specified in paragraph 12.
- If either (but not both) control or an economic interest exists, the financial statement disclosures required by FASB Statement No. 57, *Related Party Disclosures*, should be made.

The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters.

This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, before its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

Reporting of Related Entities by Not-for-Profit Organizations

Introduction

1. The purpose of this statement of position (SOP) is to provide guidance to users and preparers of not-for-profit organizations' financial statements that will produce greater uniformity and comparability in the reporting of investments in majority-owned for-profit subsidiaries, investments in less than 50-percent-owned for-profit entities, and related but separate not-for-profit organizations. This SOP does not address how to prepare consolidated financial statements,[1] nor does it address all the conceptual issues underlying the reporting of relationships not evidenced by ownership.[2]

Scope

2. This SOP—

- Amends and makes uniform the guidance concerning the reporting of related entities in the following AICPA publications:
  - Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
  - Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
  - SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*[3]
- Does not apply to entities or activities that are covered by the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

Conclusions

3. This SOP provides guidance for reporting (*a*) investments in for-profit majority-owned subsidiaries, (*b*) investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest, and (*c*) financially interrelated not-for-profit organizations.

4. Whether the financial statements of a reporting not-for-profit organization and those of one or more other entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of the disclosure that should be required, if any, should be based on the nature of the relationships between the entities.

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[1] *Consolidation* of a parent and subsidiary organizations requires the presentation of a single set of amounts for the entire reporting entity. *Combination*, as discussed in paragraphs 22 and 23 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, refers to financial statements prepared for organizations among which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. This SOP provides no guidance concerning commonly controlled not-for-profit organizations.

[2] As discussed in appendix C, the Financial Accounting Standards Board (FASB) has on its agenda a project on consolidations and related matters. One of the phases of that project concerns financial reporting guidance for not-for-profit entities.

[3] SOP 78-10 has no effective date. This SOP amends, but does not affect the status of, SOP 78-10.

Investments in For-Profit Majority-Owned Subsidiaries

5. Not-for-profit organizations with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should follow the guidance in ARB 51, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, in determining whether the financial position, results of operations, and cash flows of the for-profit entity should be included in the not-for-profit organization's financial statements.

Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest

6. Investments in common stock of for-profit entities wherein the not-for-profit organization has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, if the guidance in that Opinion requires use of the equity method, subject to the exception in paragraph 7 of this SOP. Also, not-for-profit organizations should make the financial statement disclosures required by APB Opinion 18 if the guidance in that Opinion requires them.

7. Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of applying the equity method to investments covered by paragraph 6 of this SOP.

Financially Interrelated Not-for-Profit Organizations

8. Not-for-profit organizations may be related to one or more other not-for-profit organizations in numerous ways, including ownership, *control*,[4] and *economic interest*.

9. As discussed in paragraphs 10-13, the various kinds and combinations of control and economic interest result in various financial reporting. Certain kinds of control result in consolidation (paragraph 10). Other kinds of control result in consolidation only if coupled with an economic interest (paragraph 11). Still other kinds of control result in consolidation being permitted but not required if coupled with an economic interest (paragraph 12). The existence of control or an economic interest, but not both, is discussed in paragraph 13.

10. Not-for-profit organizations with a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest in that other not-for-profit organization should consolidate that other organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.

11. In the case of (*a*) control through a majority ownership interest[5] by other than ownership of a majority voting interest, as discussed in paragraph 10, or control through a *majority voting interest in the board of the other entity* and (*b*) an economic interest in other such organizations, consolidation is

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[4] Words or terms defined in the Glossary are in italicized type the first time they appear in this SOP.

[5] Ownership of not-for-profit organizations may be evidenced in various ways because not-for-profit organizations may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms.

required, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.[6]

12. Control of a separate not-for-profit organization in which the reporting organization has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If the reporting organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

- Identification of the other organization and the nature of its relationship with the reporting organization that results in control
- Summarized financial data of the other organization including—
  - Total assets, liabilities, net assets, revenue, and expenses
  - Resources that are held for the benefit of the reporting organization or that are under its control
- The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

13. In the case of control and an economic interest, the presentation of consolidated financial statements, as discussed in paragraph 11, or the disclosures, as discussed in paragraph 12, are required. The existence of control or an economic interest, but not both, precludes consolidation, except as stated in the next sentence, but requires the disclosures set forth in FASB Statement No. 57.[7] Entities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so.

14. If consolidated financial statements are presented, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization.

Effective Date and Transition

15. This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual

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[6] Interests by not-for-profit organizations in other not-for-profit organizations may be less than complete interests. For example, a not-for-profit organization may appoint 80 percent of the board of the other not-for-profit organization. If the conditions for consolidation in this SOP are met, the basis of that consolidation would not reflect a minority interest for the portion of the board that the reporting not-for-profit organization does not control, because there is no ownership interest other than the interest of the reporting not-for-profit organization. However, some not-for-profit organizations may enter into agreements with other entities, such as sharing revenue from fund-raising campaigns, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported.

[7] The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that Statement also are required under this SOP if an economic interest exists.

expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, prior to its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

APPENDIX A

Background Information and Discussion of Conclusions

A-1. This appendix discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Background

Characteristics and Objectives of Financial Reporting

A-2. FASB Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states, among other things, that financial reporting by not-for-profit organizations should provide information—

> ...that is useful to...resource providers...in making rational decisions about the allocation of resources to those organizations. (paragraph 35)

and that is

> ...about the economic resources, obligations, and net rtesorces of an organization and the effects of transactions...that change resources and interests in those resources. (paragraph 43)

A-3. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as amended by FASB Concepts Statement No. 6, *Elements of Financial Statements*, examines the characteristics that make accounting information useful. The Statement sets forth a hierarchy of qualities, with usefulness for decision making being most important. The two primary characteristics that make accounting information useful are relevance and reliability. Comparability, which includes consistency, interacts with relevance and reliability to increase the usefulness of information.

A-4. Information about the nature of relationships and forms of control among not-for-profit organizations and between not-for-profit organizations and for-profit entities should contribute to the objectives set forth in FASB Concepts Statement No. 4, as well as meet the criteria for accounting information set forth in Concepts Statement No. 2. As indicated in paragraphs A-11 and A-12 of this SOP, the information currently presented in not-for-profit organizations' financial statements may not meet the objectives set forth in Concepts Statement No. 4.

A-5. Related but separate not-for-profit organizations and for-profit entities result from the following:

a. The decision of not-for-profit organizations to structure their operations in a manner that helps them achieve their mission

b. Investments by not-for-profit organizations in for-profit entities

Structure of Not-for-Profit Organizations

A-6. Not-for-profit organizations conduct their operations through a variety of organizational structures. *The Not-For-Profit Organization Reporting Entity* (the Holder Report), a 1986 research report by William W. Holder, identifies three basic kinds of organizational structure:

a. *Simple structures*, consisting of a single entity that conducts all operations and activities of the organization

b. *Separate entities*, conducting individual program activities

c. *Single entity and separate entities*, conducting, respectively, program activities and support and other noncentral activities, such as fund-raising

Relationship of Separate Entities to Each Other

A-7. The Holder Report, as well as other studies, identified a variety of relationships that could indicate that the resources and activities of an entity are controlled by another entity. Among the most widespread are the following:

- *Ownership*—One entity is the legal owner of another entity, either through stock ownership or some other means, such as membership in a membership corporation.
- *Board membership*—(*a*) One entity has the ability to appoint or elect a voting majority of the board of directors of another entity or (*b*) a voting majority of one entity's board, as a result of its charter or bylaws, is also a voting majority of the board of another entity.
- *Charter or bylaws*—The corporate charter or bylaws of an entity limits its activities to those that are beneficial to another entity.
- *Oversight relationship*—A national charter establishes conditions, such as financial relationships or an accreditation process, for a separate entity's use of a national name or participation in the activities of a national organization.
- *Contract*—The relationship between separate entities is spelled out in a written contract.

Factors Influencing Relationships of Separate Entities to Each Other

A-8. According to the Holder Report, the most common reasons for establishing separate entities are the following:

- *Taxes*—To ensure the income tax deductibility of contributions by donors and to avoid problems of unrelated business income for taxation purposes
- *Legal*—To limit legal liability; protect funding sources; and avoid laws, rules, and regulations perceived to be overly restrictive
- *Organization*—To establish clear-cut organizational limits of authority and autonomy for various activities
- *Public identity*—To create a separate, distinct public identity for the specific activity in question

Generally, entities that are established for these reasons are not-for-profit organizations; however, they also may be for-profit entities, principally for tax reasons.

Not-for-Profit Organization Investment Portfolio Relationships

A-9. Not-for-profit organizations' investment portfolios may include ownership interests in for-profit entities. Such investments generally are made to earn returns on assets rather than to conduct operating activities and frequently are held for long-term investment purposes. Some not-for-profit organizations holding such investments own more than 20 percent interests in these for-profit organizations; for example—

- A federated fund-raising organization may hold a majority interest in an oil company.
- A not-for-profit organization's endowment fund may include controlling interests in shopping malls, commercial buildings, and venture capital funds.

Current practice for reporting such investments is diverse, including cost, lower of cost or market, fair market value, and the equity method. Such investments generally are not reported by consolidating their financial statements with the financial statements of the reporting not-for-profit organizations.

Current Authoritative Literature

A-10. Current authoritative literature on reporting the resources and activities of related entities of which one or more is a not-for-profit organization is inconsistent. Two noteworthy instances are the following:

- Appendix B discusses the inconsistencies in the AICPA audit and accounting guides and the SOP listed in paragraph 2 of this SOP. Efforts to correct or address these inconsistencies will take a long time, and no immediate guidance is anticipated other than this SOP.
- There has been uncertainty in practice over whether and to what extent certain pronouncements of the FASB—for example, FASB Statement No. 94—apply to not-for-profit organizations. In September 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

Appendix C summarizes other projects related to this SOP and their current status.

Needs of Financial Statement Users

A-11. Because of the variety of organizational structures, the nature of the relationships among separate entities, and the inconsistency of the guidance in the current authoritative accounting literature, the needs of users of not-for-profit organizations' financial reports described in FASB Concepts Statement Nos. 2 and 4 may not be met.

A-12. Among the deficiencies noted by creditors, identified in the Holder Report, are the following:

- Relationships with and among affiliated entities and other related parties are not always clear and readily understandable in an organization's financial reports.
- Creditors sometimes are unable to understand the scope of activities and range of entities that make up the reporting entity simply by reading the financial reports.
- Substantially different reporting practices exist for similar economic circumstances.

Among the deficiencies noted by grantors and contributors, also identified in the Holder Report, are the following:

- Reporting for fund-raising and administrative activities sometimes is fragmented into more than one set of financial statements.
- The level of disclosure in financial statements about the kinds of activities conducted and the existence and inclusion of related entities is inadequate. Of specific concern is whether all the resources controlled and all the activities conducted by a not-for-profit organization are included in its financial statements.

Reporting and Disclosures

A-13. Relationships between not-for-profit organizations and other entities range from complete control of the other entities by a central organization to a loose association. These relationships have resulted in the following eight financial reporting alternatives:

a. Consolidation or combination under the guidelines in ARB 51, FASB Statement No. 94, and SOP 78-10

b. Reporting the investment under the equity method of accounting for investments

c. Reporting the investment at cost

d. Reporting the investment at market

e. Reporting the investment at the lower of cost or market

f. Disclosures similar to those under the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

g. Related-party disclosures under the guidelines of FASB Statement No. 57

h. No reporting or disclosures

Consolidation and Combination

A-14. Drawing on ARB 51, FASB Statement No. 94, paragraph 1, states:

> The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

A-15. SOP 78-10, which is included in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* and which predates FASB Statement No. 94, states in paragraphs 42 and 43:

> For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.
>
> The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of position and has concluded that it may be construed by some to be so broad, considering the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

SOP 78-10, paragraph 44, states, in part:

> ...combined financial statements should be presented if (1) control exists as defined in paragraph 42 and (2) any of the following circumstances exists:
>
> *a.* Separate entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
>
> *b.* A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.
>
> *c.* A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

Equity Method

A-16. APB Opinion 18 states in paragraph 17:

> ...the equity method of accounting for an investment in common stock should...be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

Disclosures

A-17. Paragraph 13.04 of *Audits of Providers of Health Care Services* suggests presenting "summarized information about the assets, liabilities, results of operations, and changes in fund balances of related organizations" that "describe the nature of the relationships between...the related organizations."

A-18. FASB Statement No. 57 requires the following disclosures for material related-party transactions:

- The existence and nature of the relationship
- A description of the transactions between the entities, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects of those transactions on the reporting organization's financial statements
- The dollar volume of transactions between the entities and the effects of any changes in the method of establishing their terms from the preceding period
- Amounts due from or to the related entities, and, if not otherwise apparent, the terms and manner of settlement

Discussion of Conclusions

Scope

A-19. Consistent with the May 19, 1993, exposure draft of this SOP, this SOP does not apply to entities that are included in the scope of *Audits of Providers of Health Care Services*. AcSEC considered including those entities in the scope of this SOP but exempted them for practical purposes. The ways those entities are related to each other are evolving and may not be contemplated by this SOP. For example, many of those entities are affiliated based on participation in networks of health care providers, with complex contractual agreements that make it difficult to determine whether control and economic interest exist based on the definitions in this SOP. While AcSEC believes the basic principles in this SOP also may apply to those entities, further study and deliberation are necessary to determine whether this SOP would require clarification for it to be made operational for those entities. Further, AcSEC believes (*a*) there is a need for guidance now for entities included in the scope of this SOP and (*b*) including entities covered by *Audits of Providers of Health Care Services* in the scope of this SOP likely would delay its issuance. Accordingly, AcSEC concluded it should exclude entities that are required to follow *Audits of Providers of Health Care Services* from the scope of this SOP. Guidance for reporting related entities for entities covered by *Audits of Providers of Health Care Services* is expected to be included as part of the current project to revise that guide.

Underlying Principles

A-20. The conclusions in this SOP are based on the premise that (*a*) whether the financial statements of a reporting not-for-profit organization and those of one or more other entities (either a not-for-profit organization or a for-profit entity) should be consolidated and (*b*) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

Control

A-21. This SOP does not develop new concepts concerning the definition of control. Because the FASB currently has on its agenda a project on consolidations and related matters that may result in a definition of control different from that contained in SOP 78-10, AcSEC concluded that it should not revise the definition of control at this time.

Relation to Other Guidance

A-22. This SOP makes uniform the application of APB Opinion 18 and FASB Statement No. 94 for not-for-profit organizations with the following exception: This SOP permits not-for-profit organizations that otherwise would report their investment portfolios at market value in conformity with guidance in the not-for-profit audit guides to do so instead of adopting the equity method for unconsolidated subsidiaries and 50 percent or less owned entities. AcSEC permitted this exception because it believes uniform guidance will be issued by the FASB on reporting the overall investment activities of not-for-profit organizations as part of the FASB's project on not-for-profit organizations.

A-23. The conclusions in this SOP evolve from and consider the conclusions of SOP 78-10 and *Audits of Providers of Health Care Services* to provide uniform criteria for consolidation. They provide for financial statement disclosures that can be applied objectively and that can curb potential abuses in not reporting (*a*) the results of separate but related entities established by a not-for-profit organization to raise funds on its own behalf and (*b*) assets controlled by another not-for-profit organization. (This SOP does not revise *Audits of Providers of Health Care Services*.)

A-24. This SOP requires consolidation if there is an economic interest and control by either a majority voting interest in the board of the other entity or the ability to appoint a majority of its board members. Some not-for-profit organizations are related to each other in ways that would meet the definition of control under this SOP. However, in the case of some of the organizations, no such economic interest exists. In circumstances of control other than a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest, this SOP requires the existence of an economic interest for consolidation to be required or permitted. That provision is included in order to preclude the reporting of misleading information about the assets, liabilities, results of operations, and cash flows of the reporting organization.

Economic Interest

A-25. The Glossary of this SOP states that "[a]n *economic interest* in another entity exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other organization." The Glossary includes examples of circumstances that result in economic interests, including a reporting organization assigning certain of its functions to another entity. For example, an educational institution assigning its research functions to a research corporation that holds significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly, results in an economic interest in that research corporation. Also, an organization may have an economic interest in a lobbying organization if that lobbying organization conducts any of the organization's lobbying functions and uses significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly.

Circumstances Permitting but Not Requiring Consolidation

A-26. Paragraph 12 of this SOP permits but does not require consolidation if the reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is achieved other than control through—

a. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

b. A majority voting interest in the board of the other entity.

AcSEC considered requiring consolidation in all circumstances in which the reporting not-for-profit organization controls and has an economic interest in another not-for-profit organization. However, AcSEC believes consolidation may not be meaningful in all situations in which there is control and an economic interest. For example, some national organizations may control local chapters through affiliation agreements and receive funds from those local chapters. In such circumstances, both control and an economic interest exist. However, consolidation may not be meaningful. AcSEC encourages consolidation if—

a. The reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is other than control through—

  i. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

  ii. A majority voting interest in the board of the other entity and

b. Consolidation would be meaningful.

Disclosures

A-27. AcSEC believes the disclosures required by this SOP in circumstances in which control exists by contract, agreement, or otherwise provide financial statement users with information that is more meaningful than the information they now receive under the existing not-for-profit audit guides. The disclosure requirements in this SOP are an interim step until the FASB completes its consolidations and related matters project.

Combined Financial Statements

A-28. This SOP provides guidance concerning consolidated financial statements. As discussed in footnote 1, ARB 51 provides guidance concerning combined financial statements. Paragraph 22 of ARB 51 states that "there are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements." This SOP prohibits consolidated financial statements in certain circumstances. However, it provides no guidance concerning combined financial statements of commonly controlled not-for-profit organizations, which may be presented, in certain circumstances, in conformity with the guidance in ARB 51.

Parent or Subsidiary-Only Financial Statements

A-29. This SOP provides no guidance concerning parent-entity-only or subsidiary-entity-only financial statements. Paragraph 15 of FASB Statement No. 94 precludes the use of parent-company financial statements for use as the general-purpose financial statements of the primary reporting entity. However, that Statement is silent concerning parent-company financial statements as other than general-purpose financial statements for the primary reporting entity. Generally accepted accounting principles do not preclude the issuance of subsidiary-only financial statements. However, care should be taken to include all disclosures required by FASB Statement No. 57 and other relevant pronouncements.

APPENDIX B

Other Financial Reporting Literature

B-1. The following discusses the authoritative and other financial reporting literature that is relevant to AcSEC's consideration of consolidated financial statements involving not-for-profit organizations. All references and discussion pertain to literature as it exists prior to being revised by this SOP. As discussed in paragraph 2, this SOP revises certain AICPA literature.

SOP 78-10

B-2. SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, is discussed in paragraph A-15 of this SOP. (As discussed in paragraph 2 of this SOP, this SOP amends SOP 78-10.)

Audits of Providers of Health Care Services

B-3. The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*, paragraph 13.02, recommends consolidation or combination of organizations related to health care entities by direct or common ownership in accordance with the provisions of ARB 51. In cases in which related organizations are controlled through means other than direct or common ownership and ARB 51 does not require consolidation, *Audits of Providers of Health Care Services* does not recommend consolidation or combination.

B-4. In circumstances in which *Audits of Providers of Health Care Services* does not recommend consolidation or combination, paragraph 13.04 of that guide requires disclosure of certain summarized information concerning the related organizations if control and at least one of the following circumstances exist:

a. The organization has solicited funds in the name of the health care entity and with the expressed or implied approval of the health care entity, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the health care entity or used at its discretion or direction.

b. The health care entity has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the health care entity.

c. The health care entity has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is acting primarily for the benefit of the health care entity.

(As discussed in paragraph 2 of this SOP, this SOP does not amend *Audits of Providers of Health Care Services*.)

Audits of Colleges and Universities

B-5. The AICPA Industry Audit Guide *Audits of Colleges and Universities*, paragraph 11.09, states:

> For adequate disclosure, all separately incorporated but related units for which the reporting institution is fiscally responsible, such as university presses, intercollegiate athletics, and research foundations, should be (1) included in the financial statements, (2) adequately disclosed by notes, or (3) presented in separate financial statements accompanied by and cross-referenced in the basic financial statements of the institution.

(As discussed in paragraph 2 of this SOP, this SOP amends *Audits of Colleges and Universities*.)

Audits of Voluntary Health and Welfare Organizations

B-6. The AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* provides no guidance on whether consolidated financial statements should be presented. However, paragraphs 7.08 and 7.09 provide guidance for determining whether auditors should audit the financial statements of organizations associated with the reporting not-for-profit organization. (As discussed in paragraph 2 of this SOP, this SOP amends *Audits of Voluntary Health and Welfare Organizations*.)

APPENDIX C

Other Projects Related to This SOP

FASB Project on Consolidations and Related Matters

C-1. This project is addressing various issues concerning the reporting entity, including those relating specifically to not-for-profit organizations. The FASB issued its September 10, 1991, Discussion Memorandum, *Consolidation Policies and Procedures*. The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters.

FASB Project on Investments

C-2. This project is addressing various issues concerning investments held by not-for-profit organizations. The project is in the preliminary stages. The conclusions in this SOP will be reconsidered when the FASB completes its project on investments, which may affect the conclusions concerning investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest and other related matters. [*In November 1995, the FASB issued FASB Statement No. 124,* Accounting for Certain Investments Held by Not-for-Profit Organizations, *which does not effect the conclusions of this SOP.*]

AICPA Project on the Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations

C-3. In September 1994, AcSEC issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

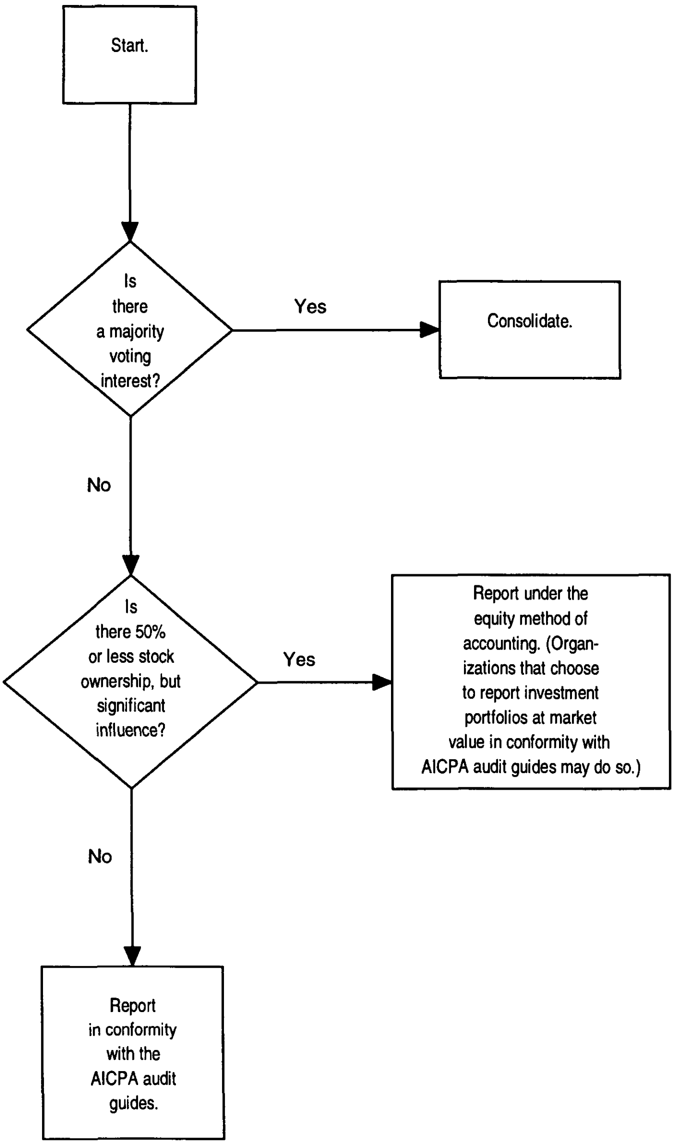
AICPA Accounting and Audit Guide Revisions

C-4. The AICPA will revise the existing audit and accounting guides for not-for-profit organizations and colleges and universities to reflect the accounting and reporting requirements of FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*, among other things.

APPENDIX D

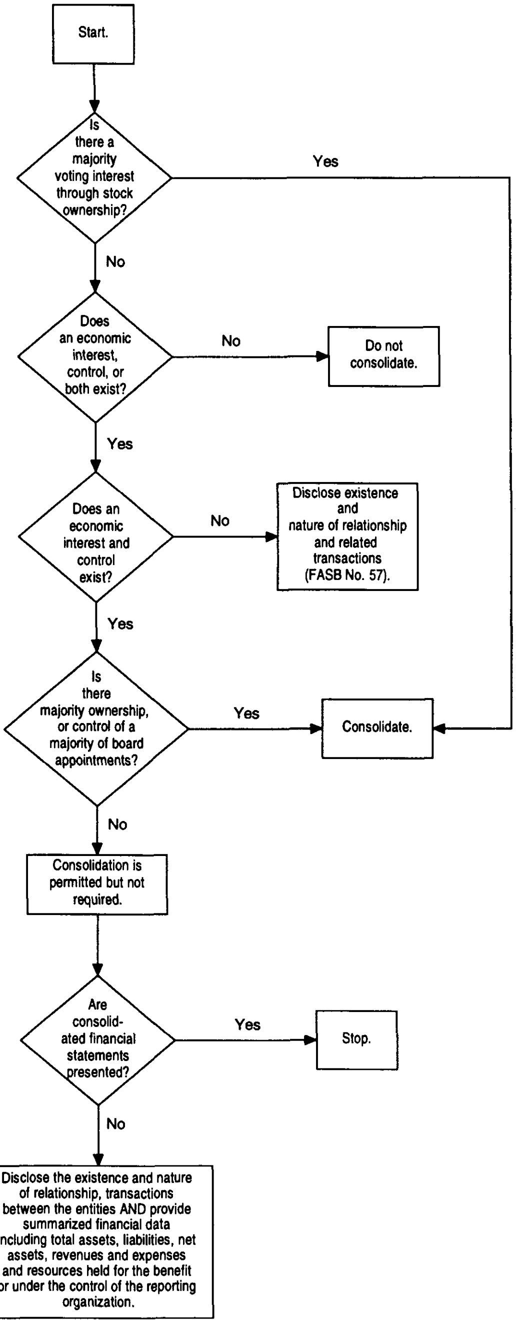
Flowcharts and Decision Trees[8]

Ownership of a For-Profit Entity



[8] The flowcharts and decision trees summarize certain guidance in this SOP and are not intended as substitutes for the SOP.

Relationship With Another Not-for-Profit Organization



Glossary

Control. The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Economic interest. An interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity. The following are examples of economic interests:

- Other entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of the reporting organization.
- A reporting organization assigns certain significant functions to another entity.
- A reporting organization provides or is committed to provide funds for another entity or guarantees significant debt of another entity.

Majority voting interest in the board of another entity. For purposes of this SOP, a majority voting interest in the board of another entity is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more entity A board members, officers, or employees serve on or may be appointed at entity A's discretion to the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on the entity B board, entity A does not have a majority voting interest in the board of entity B.

Chapter 9

Property and Equipment

Introduction

9.01 Not-for-profit organizations use various kinds of property and equipment to provide goods and services to beneficiaries, customers, and members. Property and equipment includes all long-lived tangible assets held by not-for-profit organizations, except collection items[1] and assets held for investment purposes.

9.02 Property and equipment commonly held by not-for-profit organizations include the following:

- Land used as a building site not subject to depreciation
- Land improvements, buildings and building improvements, equipment, furniture and office equipment, library books, motor vehicles, and similar depreciable assets
- Leased property and equipment (capitalized in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*)
- Improvements to leased property
- Construction in process
- Contributed use of facilities and equipment (recognized in conformity with FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*)

Recognition and Measurement Principles

9.03 Not-for-profit organizations acquire the use of property and equipment through purchases, trade-ins, self-construction, leases, and contributions. Except as discussed in this chapter, the recognition and measurement principles for property and equipment acquired by not-for-profit organizations in exchange transactions are similar to those used by business organizations.

9.04 Property and equipment used in exchange transactions (other than lease transactions), such as federal contracts, in which the resource provider retains legal title during the term of the arrangement should be reported as a contribution at fair value at the date received by the not-for-profit organization only if it is probable that the organization will be permitted to keep the assets when the arrangement terminates. The terms of such arrangements should be disclosed in notes to the financial statements.

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[1] Because of their unique nature, collection items are reported differently from how other long-lived tangible assets are reported. Chapter 7, "Other Assets," of this Audit and Accounting Guide (Guide), discusses accounting for collection items.

Contributed Property and Equipment

9.05 Contributions of property and equipment (including unconditional promises to give property and equipment) should be recognized at fair value[2] at the date of contribution and, depending on donor restrictions and the organization's accounting policy, should be included in permanently restricted,[3] temporarily restricted, or unrestricted net assets. If the donors stipulate how or how long contributed property and equipment must be used by the organization, the contribution should be reported as restricted support. If the donors do not specify such restrictions, the contribution should be reported as restricted support if the organization has adopted an accounting policy of implying a time restriction on the use of such assets that expires over the assets' useful lives. In the absence of donor restrictions or an organization's policy of implying time restrictions, contributions of long-lived assets should be reported as unrestricted support. Unconditional promises to give property and equipment should be recognized as receivables in conformity with FASB Statement No. 116 and with chapter 5 of this Guide. Contributions of the use of property and equipment in which the donor retains legal title to the assets are discussed in paragraphs 5.42 and 5.43.

9.06 Similar to items acquired in exchange transactions, the amount initially recognized for contributed property and equipment should include all the costs incurred by the organization to place those assets in use. Examples of such costs include the freight and installation costs of contributed equipment and cataloging costs for contributed library books.

Depreciation

9.07 Paragraph 149 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, describes depreciation as a "systematic and rational" process for allocating the cost of using up assets' service potential or economic benefit over the assets' useful economic lives. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires all not-for-profit organizations to recognize depreciation for all property and equipment except land used as a building site and similar assets and collections.[4] Depreciation should be recognized for contributed property and equipment as well as for plant and equipment acquired in exchange transactions.

9.08 Depreciation expense should be reported in a statement of activities as a decrease in unrestricted net assets. If the property and equipment being depreciated have been contributed to the organization with donor-imposed restrictions on the item's use, temporarily restricted net assets should, over time, be reclassified as unrestricted net assets in a statement of activities as those restrictions expire. The amount reclassified may or may not be equal to the amount of the related depreciation. The amount to be reclassified should be based on the length of time indicated by the donor-imposed restrictions while the amount of depreciation should be based on the useful economic life

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[2] Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses alternative methods of measuring the fair value of contributed assets.

[3] In practice, contributions of depreciable assets generally are not permanently restricted.

[4] The terms of certain grants and reimbursements from other organizations may specify whether depreciation or the entire cost of the asset in the year of acquisition should be included as a cost of activities associated with those grants or reimbursements for contractual purposes (sometimes referred to as *allowable costs*). Those terms should not affect the recognition and measurement of depreciation for financial reporting purposes.

of the asset. For example, a computer with an estimated useful economic life of five years may be contributed by a donor and restricted for a specific use by the organization for three years. Reclassifications are also necessary if the not-for-profit organization has adopted an accounting policy that implies a time restriction on contributions of property and equipment that expires over the useful life of the contributed assets. Reclassifications should be included as "Net Assets Released from Restrictions" in a statement of activities.

Impairment of Long-Lived Assets

9.09 In conformity with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, not-for-profit organizations should review long-lived assets to be held and used whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, organizations should estimate the future cash flows expected to result from (*a*) the use of the asset, such as fees or contributions, and (*b*) the asset's eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss should be recognized.[5] Otherwise, an impairment loss should not be recognized. Measurement of the impairment loss should be based on the fair value of the assets. The Statement also prescribes reporting and disclosure requirements for such losses.

9.10 Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, provides guidance for certain assets to be disposed of. FASB Statement No. 121 provides that all long-lived assets and certain identifiable intangibles to be disposed of that are not covered by that Opinion and for which management, having the authority to approve the action, has committed to a plan to dispose of the assets, whether by sale or abandonment, should be reported at the lower of carrying amount or fair value less cost to sell. The Statement also prescribes reporting and disclosure requirements for such losses.

9.11 The provisions of the Statement are effective for financial statements issued for fiscal years beginning after December 15, 1995. Impairment losses resulting from application of the Statement should be reported in the statement of activities in the period in which the recognition criteria are first met. The initial application of the Statement to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

Gains and Losses

9.12 Gains and losses recognized on property and equipment, including impairment losses recognized in conformity with FASB Statement No. 121,

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[5] Paragraph 8 of FASB Statement No. 121 provides that for purposes of estimating expected future cash flows, "assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of cash flows of other groups of assets." Paragraph 10 provides that in limited circumstances, the comparison of the estimated cash flows with the carrying amount of the assets "will be applicable only at the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings....If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement."

should be classified in a statement of activities as changes in unrestricted net assets unless explicit donor stipulations or law require their use to be restricted. In those situations, gains or losses should be classified as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate.

Financial Statement Presentation

9.13 A statement of financial position or related notes should include the balances of each major class of property and equipment. The basis of valuation—for example, cost for purchased items and fair value for contributed items—should also be disclosed. Separate disclosure should also be made of the following items:

- Nondepreciable assets
- Property and equipment not held for use in operations, for example, items held for sale or for investment purposes or construction in process
- Assets restricted by donors to investment in property and equipment
- Improvements to leased facilities and equipment
- Assets (and related obligations) recognized under capital leases (in conformity with FASB Statement No. 13)
- Capitalized interest (in conformity with FASB Statement Nos. 34, *Capitalization of Interest Cost*, and 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*)
- Disclosures required by FASB Statement No. 121, if applicable
- Significant accounting policies concerning property and equipment, such as the following:
  - The capitalization policy adopted
  - Whether time restrictions are implied on the use of contributed long-lived assets (and contributions of assets restricted to purchase them) received without donor stipulations concerning how long the contributed assets must be used[6]
  - Whether donor-restricted contributions of long-lived assets are reported as unrestricted or restricted support when restrictions are satisfied in the same reporting period in which the contributions are received[7]

9.14 Accumulated depreciation, either for each major class of property and equipment or in total, should be disclosed (*a*) as a deduction or parenthetically in a statement of financial position or (*b*) in the notes to the financial statements. The amount of depreciation expense for the period and the method or methods used to compute depreciation for the major classes of property and equipment should also be disclosed.

9.15 The notes to the financial statements should also include disclosures concerning the liquidity of the organization's property and equipment, includ-

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[6] Paragraph 5.65 includes examples of how these alternative policies might be disclosed in notes to the financial statements.

[7] See footnote 6.

ing information about limitations on their use. For example, information should be provided about—

- Property and equipment pledged as collateral or otherwise subject to lien
- Property and equipment acquired with restricted assets where title may revert to another party, such as a resource provider
- Donor or legal limitations on the use of or proceeds from the disposal of property and equipment

Auditing

9.16 As discussed in chapter 5 of this Guide, a not-for-profit organization may have access to the use of property or equipment that is neither owned nor leased. For example, property or equipment may be provided by a related organization (such as a religious order), by unrelated organizations under affiliation programs, or by a governmental agency or unit. The auditor should inquire into, and the financial statements should disclose, the nature of any relationship between the organization and the owners of the property or equipment.

9.17 Many audit objectives, controls, and auditing procedures for property and equipment of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Contributed Property and Equipment			
Valuation	Contributed property and equipment is reported at fair value at the date of contribution.	Controls ensure that contributions of property and equipment are known and recorded and that documentation supports the determination of their fair value.	Review documentation supporting the determination of fair value.
Rights and obligations	Restrictions on contributed property and equipment have been met.	Contributions of property and equipment are reviewed for restrictions and management monitors compliance with restrictions.	Review donor correspondence to determine the presence or absence of restrictions. Review minutes of governing board and governing board committee meetings for evidence of donor restrictions. If specific property or equipment is restricted, review contributed property and equipment transactions for propriety of use and dispositions.
Presentation and disclosure	Property and equipment is reported in the proper net asset class.		Review documentation underlying contributions of property and equipment for propriety of classification.

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Property and Equipment Not Held for Use in Operations			
Presentation and disclosure	Property and equipment not used in operations but held as an investment or for sale is separately reported.	Property records segregate property and equipment not used for operating purposes.	Determine that property and equipment not held for operating purposes is reported separately.
Property and Equipment Additions			
Rights and obligations	Appropriate resource provider approvals, if required, have been obtained for property and equipment additions.	Management monitors compliance with resource provider regulations related to additions to property and equipment. Additions are authorized in the capital budget.	Determine compliance with resource provider requirements.
Reclassification of Temporarily Restricted Net Assets			
Presentation and disclosure	Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities over the term of the donor-imposed restrictions.		Determine that appropriate reclassifications are made on the statement of activities over the term of the donor-imposed restrictions.

Chapter 10

Debt and Other Liabilities

Introduction

10.01 Many obligations of not-for-profit organizations are similar to those of for-profit entities. This chapter considers debt and other liabilities that are not discussed elsewhere in this Audit and Accounting Guide (Guide) and that present accounting and auditing issues unique to not-for-profit organizations.

Tax-Exempt Financing

10.02 Some not-for-profit organizations finance part of their activities from the proceeds of tax-exempt bonds and other obligations issued through state and local financing authorities. Because not-for-profit organizations are responsible for the repayment of those obligations, such financing should be reported as liabilities on their statements of financial position.

Current and Deferred Tax Liabilities

10.03 Although not-for-profit organizations are generally tax-exempt under various Internal Revenue Code (IRC) sections,[1] some may be subject to taxes on various portions of their income, such as federal excise taxes on investment income or federal and state income taxes on unrelated business income.[2] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, provides guidance on recognizing (*a*) the amount of taxes payable (or refundable) for the current year and (*b*) deferred-tax liabilities (and assets) for the estimated future tax consequences of temporary differences and carryforwards.

Deferred Revenue

10.04 Resources received in exchange transactions from customers, patients, and other service beneficiaries for specific projects, programs, or activities that have not yet taken place should be recognized as liabilities to the extent that the earnings process has not been completed. For example, resources received from the advance sale of season theater tickets should be recognized as deferred revenue, representing the obligation to hold the performances. That revenue is earned as the theater performances are held.

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[1] Some organizations may meet the definition of a not-for-profit organization, as discussed in paragraphs 1.01 and 1.02 of this Guide, but may nevertheless not be tax-exempt under the IRC. For example, an organization that may otherwise qualify for tax-exempt status under the IRC may lose its tax exemption because it has violated the private inurement rules applicable to tax-exempt organizations. Chapter 15, "Tax Considerations," of this Guide, discusses various requirements for maintaining tax-exempt status under the IRC.

[2] Chapter 15 of this Guide discusses tax issues concerning not-for-profit organizations.

Refunds Due to and Advances From Third Parties

10.05 Some not-for-profit organizations receive (*a*) advances from third parties, such as government agencies and foundations, based on the estimated cost of providing services to constituents and (*b*) resources from third parties to be used to make loans to the organization's constituents. Advances from third parties for services not yet performed, as well as refunds due to third parties for amounts previously received under such agreements, should be included as liabilities on a statement of financial position.

Promises to Give

10.06 A promise to give carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. Paragraph 18 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, requires donors to recognize a liability for unconditional promises made to give cash or other assets to recipients or to settle or cancel the recipients' liabilities. Unconditional promises to give should be recognized at the time the donor has an obligation to transfer the promised assets in the future, which generally occurs when the donor approves a specific grant or when the recipient is notified. If a donor explicitly reserves the right to rescind an intention to contribute, or if a solicitation explicitly allows a donor to rescind the intention, a promise to give should not be recognized by the donor. If payments of the unconditional promise to give are to be made to a recipient over several fiscal periods and the recipient is subject only to routine performance requirements, a liability and an expense for the entire amount payable should be recognized and measured at the present value of the amounts to be paid. In conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently.[3] Conditional promises to give should not be recognized until the conditions are substantially met.[4]

10.07 In conformity with paragraph 15 of APB Opinion No. 21, the interest method should be used to amortize discounts on contributions payable that are measured at present value. Other methods of amortization may be used if the results are not materially different. The discount should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are paid. The amortization of any discount related to unconditional promises to give should be reported as a component of contribution expense, in the same functional classification in which the promise to give was reported.

10.08 In addition to disclosures required by FASB Statement Nos. 5, *Accounting for Contingencies*, and 47, *Disclosure of Long-Term Obligations*, the notes to the financial statements should include a schedule of unconditional promises to give that shows the total amount separated into amounts payable in less than one year, in one to five years, and in more than five years and the unamortized discount.

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[3] The discount rate may differ from the discount rate used to discount contributions receivable.

[4] Chapter 5, "Contributions Received and Agency Transactions," of this Guide, provides additional guidance for recognizing conditional promises to give.

Annuity Obligations

10.09 Some contributions received by not-for-profit organizations, such as interests in charitable gift annuity contracts and charitable remainder and lead trusts, impose obligations on the organization to make future payments to others. Guidance for reporting such contributions, often referred to as "split-interest agreements," is included in chapter 6, "Split-Interest Agreements," of this Guide. Annuity obligations arising from split-interest gifts should be recognized as liabilities and measured at the present value of the actuarially determined obligation. Periodic revaluations of these liabilities result in changes in the value of split-interest agreements, which should be included as changes in the appropriate net asset classes in a statement of activities.

Amounts Held for Others Under Agency Transactions

10.10 Some not-for-profit organizations receive assets in agency transactions. Amounts held under agency transactions should be included as liabilities in statements of financial position. Paragraphs 5.04 and 5.06 discuss agency transactions in more detail.

Contingencies

10.11 In conformity with FASB Statement No. 5, notes to the financial statements may have to include information about, or a liability may have to be accrued for, loss contingencies. Examples of circumstances that may result in such contingencies include the following:

- Noncompliance with donor-imposed restrictions on contributed assets
- Problems with the organization's tax-exempt status, or that a determination letter regarding that status has not been received

Auditing

10.12 Many audit objectives, controls, and auditing procedures for debt and other liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Tax-Exempt Financing			
Completeness; presentation and disclosure	Amounts related to tax-exempt debt are recognized in the financial statements and related disclosures are adequate.	Reconcile outstanding balances and other relevant data with information received from the trustee.	Confirm outstanding balances and other relevant data with trustee. Review financing agreements to ascertain that information about tax-exempt financing is properly reported and disclosed. Review minutes of governing board and governing board committee meetings for information about tax-exempt financing.
Promises to Give			
Existence/ occurrence	Amounts recognized as contributions made and related liabilities represent valid unconditional promises to give.	Controls ensure that only unconditional contributions made and promises to give are recognized in the financial statements.	Examine documentation supporting recognition of contributions made and related liabilities, including information such as the absence of conditions and the periods over which the promises to give become due.

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Completeness	All unconditional contributions made and promises to give are recognized.	Controls ensure that all unconditional contributions made and promises to give are recognized in the financial statements.	Review minutes of governing board and governing board committee meetings for information about contributions made and promises to give.
			Review cash disbursements subsequent to year-end to ascertain that contributions made were recorded in the proper period.
Valuation	Contributions made and related liabilities expected to be paid beyond one year are measured at the present value of the amounts expected to be paid.		Review and test the method used for valuing promises to give collectible more than one year from the date of the financial statements.

Chapter 11

Net Assets

Introduction

11.01 Paragraph 49 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, defines *net assets* as "the residual interest in an entity's assets remaining after liabilities are deducted."[1] As a residual interest, net assets cannot be measured independently of an organization's assets and liabilities. Changes in net assets result from transactions and other events and circumstances in which total assets and total liabilities change by different amounts. In many not-for-profit organizations, such changes include nonreciprocal transfers of assets received from donors who do not expect to receive either repayment or proportionate economic benefit in return. Display of and disclosures about net assets and changes in them are intended to assist donors and other users in assessing an organization's efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so.

11.02 Changes in net assets result from revenues, expenses, gains, and losses; those changes are discussed in chapters 5 through 10, 12, and 13 of this Guide. This chapter describes principles for reporting total net assets in statements of financial position and changes in total net assets in statements of activities, as well as related disclosures.

Net Asset Classes

11.03 The following three classes of net assets should, if applicable, be reported in statements of financial position: (*a*) permanently restricted, (*b*) temporarily restricted, and (*c*) unrestricted.[2] Net assets should be included in one of the three classes depending on the presence and type of donor-imposed restrictions limiting an organization's ability to use or dispose of specific contributed assets or the economic benefits embodied in those assets. Donor stipulations should not be considered restrictions unless they include limitations on the use of contributed assets that are more specific than the broad limits imposed by the organization's purpose and nature.

11.04 Donor-imposed restrictions generally apply to net assets. Donors may also restrict specific assets as to their use (for example, land contributed for a park) or over time (for example, contributed securities that must be held in perpetuity). Paragraphs 3.03 and 11.12 of this Guide discuss reporting requirements for specific assets that have been received with donor-imposed restrictions.

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[1] Though not-for-profit organizations may use other terms, such as *equity*, this Accounting and Auditing Guide (Guide) uses the term *net assets* to describe the residual interest.

[2] Though FASB Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, encourages the use of the terms *unrestricted*, *temporarily restricted*, and *permanently restricted* net assets, other titles for these classes may also be used, and further disaggregation of total net assets may also be reported. For example, *equity* may be used for net assets and unrestricted net assets may be labeled *other* and subdivided into *board-designated* net assets and *undesignated* net assets.

Permanently Restricted Net Assets

11.05 Permanently restricted net assets must be maintained by the organization in perpetuity. Permanently restricted net assets increase when organizations receive contributions for which donor-imposed restrictions limiting the organization's use of an asset or its economic benefits neither expire with the passage of time nor can be removed by the organization's meeting certain requirements. For example, contributions of cash or securities restricted by the donor with the stipulation that they be invested in perpetuity and contributions of collection items (if they are capitalized[3]) required by the donor to be maintained permanently in the organization's collections should be recognized as increases in permanently restricted net assets.

11.06 Permanently restricted net assets may also change as a result of increases and decreases in existing assets that are subject to permanent restrictions. For example, increases in the carrying amounts of assets that are invested in perpetuity because of donor-imposed restrictions should be recognized as increases in permanently restricted net assets to the extent that donor stipulations or applicable law requires those increases to be retained permanently.

Temporarily Restricted Net Assets

11.07 Temporarily restricted net assets are those net assets whose use by the organization has been limited by donors (*a*) to later periods of time or after specified dates[4] or (*b*) to specified purposes. For example, contributions restricted by the donor to use by the organization over the next five years or to support a specific future program should be recognized as increases in temporarily restricted net assets. Contributions of assets (such as equipment or buildings) that by their nature are used up over time and that the donor stipulates must be used by the organization should also be recognized as increases in temporarily restricted net assets.[5]

11.08 Temporarily restricted net assets may also change as a result of increases and decreases in existing assets or the economic benefits embodied in those assets that are subject to donor-imposed temporary restrictions. For example, if the donor has stipulated that income earned on temporarily restricted net assets must be added to principal until the principal is spent for a restricted purpose, the income should be reported as increases in temporarily restricted net assets.

Unrestricted Net Assets

11.09 Unrestricted net assets include those net assets whose use is not restricted by donors, even though their use may be limited in other respects, such as by contract or by board designation. Changes in net assets arising from exchange transactions (except income and gains on assets that are restricted by donors or by law) should be included in the unrestricted class.

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[3] Chapter 7, "Other Assets," of this Guide, discusses accounting policies concerning the capitalization of collection items.

[4] Contributions received with restrictions that are met in the same reporting period may be reported as unrestricted if the organization discloses such a policy and reports consistently from period to period. Paragraph 5.30 provides further guidance concerning that policy.

[5] Some organizations may adopt an accounting policy of implying time restrictions on contributed long-lived assets in the absence of explicit donor-imposed restrictions. Paragraphs 5.33 and 5.34 provide additional guidance on alternative policies.

Reclassifications

11.10 Reclassifications of net assets—that is, simultaneous increases in one net asset class and decreases in another—should be made if (*a*) the organization fulfills the purposes for which the net assets were restricted, (*b*) donor-imposed restrictions expire with the passage of time or with the death of an annuity beneficiary (if the net assets are not otherwise restricted), (*c*) a donor withdraws, or court action removes, previously imposed restrictions, or (*d*) donors impose restrictions on otherwise unrestricted net assets.[6] For example, the amount of a donor's contribution that must be used by the organization for a specified program would be reclassified from temporarily restricted to unrestricted net assets in the period in which the organization conducts the program.[7] Paragraph 9.08 of this Guide discusses reclassifications concerning the use of contributed depreciable assets.

Disclosure

11.11 A statement of financial position should include, at a minimum, the amounts of total permanently restricted, temporarily restricted, and unrestricted net assets and the amount of total net assets. A statement of activities should include the amount of total changes in net assets and of changes in each net asset class. These amounts should articulate with the net asset amounts in the statement of financial position. Reclassifications of amounts between net asset classes should be reported separately from other transactions in the statement of activities. Specific changes in each net asset class should be aggregated into reasonably homogeneous groups.

11.12 Information about the following should be shown on the face of the financial statements or in the notes:

- Different kinds of permanent restrictions, such as those related to collection items and other specific assets to be held in perpetuity and to assets that have been contributed by donors with stipulations that they be invested in perpetuity
- Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or the acquisition of long-term assets

Separate disclosures of significant limitations other than those imposed by donors, such as those imposed by governing boards, are permitted to be made on the face of the financial statements or in the notes to the financial statements.

Auditing

11.13 Since net assets cannot be measured independently of an organization's assets and liabilities, the auditor's consideration of net asset balances generally focuses on the assertions about rights and obligations and presentation and disclosure. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

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[6] Paragraph 5.28 discusses donors imposing restrictions on otherwise unrestricted net assets.

[7] A purpose restriction is often fulfilled when the organization incurs an expense or recognizes a liability to a vendor to acquire goods or services that satisfies the restriction. Paragraph 5.32 of this Guide discusses appropriate accounting when expenses are incurred for a purpose for which both unrestricted and temporarily restricted net assets are available.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Rights and obligations	Net assets are used and accounted for in accordance with donor restrictions.	Management monitors compliance with donor restrictions.	Review minutes of governing board and governing board committee meetings for evidence of donor restrictions. Determine compliance with donor restrictions; test expenditures to determine that restricted net assets are used for their restricted purposes.
Presentation and disclosure	Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities when donor-imposed restrictions have been fulfilled.	Controls ensure that reclassification of temporarily restricted net assets occurs when donor-imposed restrictions have been fulfilled.	Determine that appropriate reclassifications are made on the statement of activities when donor-imposed restrictions have been fulfilled.

Chapter 12

Revenues and Receivables From Exchange Transactions

Introduction

12.01 This chapter discusses recognition, measurement, and display issues for revenues and related receivables arising from exchange transactions.[1] Because of the specialized nature of investment activities, they are discussed separately in chapter 8, "Investments," of this Audit and Accounting Guide (Guide). Chapter 5, "Contributions Received and Agency Transactions," of this Guide, includes guidance on distinguishing exchange transactions from contributions and agency transactions.

Revenues

12.02 Paragraph 78 of FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, defines *revenues* as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." Exchange transactions that give rise to revenues for not-for-profit organizations typically involve their efforts to provide goods or services to members, clients, students, customers, and other beneficiaries for a fee.

12.03 Revenues are distinguished from gains, which are increases in an organization's net assets from peripheral or incidental transactions. In some situations, judgment is required to determine whether an increase in net assets should be reported as a revenue or as a gain. That determination should be based on the relationship of the transaction to the organization's activities. Transactions and other events that would properly be considered part of one organization's ongoing major or central activities (and hence give rise to revenues) may be considered peripheral for other organizations (and hence give rise to gains). For example, sales of computer equipment by a college store should be reported as revenues if such sales are considered part of the college's ongoing major or central activities. Sales of old computer equipment used in a museum's administrative offices would, however, be reported as gains if such sales are peripheral and if the equipment were sold above book value. Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses reporting gains from exchange transactions.

Recognition, Measurement, and Display

12.04 The recognition, measurement, and display of revenues and related receivables arising from exchange transactions are similar for both not-for-profit and for-profit entities. Revenues from exchange transactions should be rec-

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[1] Paragraph 48 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines *exchange transactions* as "reciprocal transfers in which each party receives and sacrifices approximately equal value."

ognized based on accrual accounting principles and should be measured by the increase in cash, receivables, or other assets or by the decrease in liabilities resulting from the transaction.[2] Revenues from exchange transactions should be reported as increases in unrestricted net assets in a statement of activities. As discussed in chapter 3, "Basic Financial Statements," of this Guide, further classifications (for example, between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes stipulated by FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.*

12.05 Revenues from exchange transactions should generally be reported gross of any related expenses.[3] If the organization regularly provides discounts (such as financial aid for students that is not reported as an expense, reduced fees for services, or free services) to certain recipients of its goods or services, revenues should be reported net of those discounts.[4, 5]

12.06 Receivables arising from exchange transactions should be reported at net realizable value if the amounts are due within one year. Long-term receivables should be reported in conformity with Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*. Receivables arising from exchange transactions should be reported net of allowances for uncollectible amounts, if applicable.

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[2] Consistent with generally accepted accounting principles, interest on loans made to students and to other individuals or organizations should be recognized as revenue when earned.

[3] Expenses that are directly related to specific gross revenues may, however, be displayed sequentially with those revenues. For example, gross revenues from special events less the direct costs related to those events, followed by a subtotal, may be reported in a statement of activities. Chapter 13 of this Guide discusses reporting of special events.

[4] Net revenue may be reported as a single line item in a statement of activities, or the gross revenue is permitted to be reported less the related discount, provided that the discount is displayed immediately beneath the revenue.

[5] Paragraph 13.07 provides guidance concerning whether reductions in amounts charged for goods or services should be reported as discounts or expenses.

Chapter 13

Expenses, Gains and Losses

Introduction

13.01 Generally, expenses, gains, and losses of not-for-profit organizations are similar to those of for-profit organizations and are recognized, measured, and displayed similarly. This chapter discusses certain expense, gain, and loss recognition, measurement, and display issues that are unique to not-for-profit organizations and that are not covered elsewhere in this Audit and Accounting Guide (Guide).

Expenses

13.02 Paragraph 80 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, defines *expenses* as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Expenses are distinguished from losses, which are decreases in an organization's net assets from peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the organization except those that result from expenses.

13.03 Expenses should be reported in a statement of activities as decreases in unrestricted net assets. As discussed in chapter 3, "Basic Financial Statements," of this Guide, further classifications (such as between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes required by FASB Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations.*

13.04 Paragraph 26 of FASB Statement No. 117 specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities.[1] No similar requirement exists with respect to losses.[2] Voluntary health and welfare organizations[3] are

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[1] Reporting information about the functional classification of expenses may require the allocation of costs that benefit two or more functions. All references in this Guide to the allocation of costs of informational materials and activities that include a fund-raising appeal among functions are subject to the constraints imposed by applicable AICPA guidance on that subject. This Guide supersedes Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into this Guide in paragraphs 13.31 through 13.40. On March 11, 1998, the AICPA issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, which is included as appendix C to this Guide. SOP 98-2 is effective for financial statements for years beginning on or after December 15, 1998, with earlier application encouraged. SOP 98-2 amends paragraphs 13.17, 13.19, 13.20, and 13.31 through 13.40 of this Guide. Those amendments will be reflected in conforming changes made to this Guide prior to the effective date of SOP 98-2.

[2] Paragraphs 13.02 and 13.12 through 13.14 of this Guide discuss the differences between expenses and losses.

[3] Voluntary health and welfare organizations are defined in appendix D of FASB Statement No. 117 and in the Glossary of this Guide.

required to report information about functional classifications, together with information about expenses by their natural classifications (such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees), in a matrix format in a separate financial statement.[4] FASB Statement No. 117 encourages but does not require other not-for-profit organizations to provide information about expenses by their natural expense classification.

Expense Recognition Issues

13.05 Expenses are recognized when an organization's economic benefits are used up in delivering or producing goods, rendering services, or other activities or when previously recognized assets are expected to provide reduced or no future benefits. Some expenses, such as cost of goods sold, are recognized simultaneously with revenues that result directly and jointly from the same transactions or other events as the expenses. Some expenses, such as salaries, are recognized when cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. Some expenses, such as depreciation, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide services. An expense or loss is also recognized if it becomes evident that the previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.

Fund-Raising Costs

13.06 Fund-raising costs, including the cost of special fund-raising events, are incurred to persuade potential donors to make contributions to an organization and should be expensed as incurred.[5] Fund-raising costs incurred in one period, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity, may result in contributions that will be received in future periods. These costs also should be expensed as incurred.

Financial Aid and Other Reductions in Amounts Charged for Goods and Services

13.07 Some not-for-profit organizations provide reductions in amounts charged for goods or services, such as financial aid provided by colleges and universities. Reductions in amounts charged for goods or services provided by a not-for-profit organization should be reported as expenses if such reductions are given in exchange for goods or services provided to the organization, such as part of a compensation package. Amounts reported as expenses for such reductions should be reported in the same functional classification in which the

[4] Not-for-profit organizations may have various kinds of functions. The discussion in this Guide focuses on program, management and general, and fund-raising for illustrative purposes, because the Accounting Standards Executive Committee and the Not-for-Profit Organizations Committee (Committees) believe the use of those functional classifications will likely become predominant practice. However, the Committees neither encourage nor discourage the use of those or other functional classifications. Accordingly, the classifications used in the matrix may include program, management and general, and fund-raising or other classifications, such as cost of sales or investing.

[5] Costs are incurred when the item or service has been received.

cost of the goods or services provided to the organization are reported. If reductions in amounts charged for goods or services provided by a not-for-profit organization are given other than in exchange for services provided to the organization, such amounts should be reported as follows:

- as expenses to the extent that the organization incurs incremental expense in providing such goods or services
- as discounts[6] if the organization incurs no incremental expense in providing such goods or services

Advertising Costs

13.08 SOP 93-7, *Reporting on Advertising Costs*, provides recognition, measurement, and disclosure guidance for the advertising activities of all entities, including not-for-profit organizations. (SOP 93-7 specifically notes, however, that fund raising by not-for-profit organizations is not considered advertising and is not within the scope of the SOP.) SOP 93-7 requires certain disclosures about advertising activities, including disclosure of total advertising costs for a period.

13.09 SOP 93-7 defines *advertising* as "the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services." Advertising by a not-for-profit organization also includes activities to create or stimulate a desire to use the organization's products or services that are provided without charge.

13.10 Advertising costs should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising that results in probable future benefits. Direct-response advertising should be capitalized if it is expected to result in future benefits, as in sales resulting from direct response advertising of merchandise in excess of future costs to be incurred in realizing those revenues. If no future revenues are anticipated, however, because the products or services advertised are being provided by the organization without charge, there is no basis for capitalizing the costs of direct-response advertising after the first time the advertising takes place.

Contributions Made

13.11 FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, provides guidance on contributions made as well as contributions received. The recognition rules for contributions made are discussed in paragraph 10.06 of this Guide. The amortization of any discount related to unconditional promises to give should be reported in the same functional classification in which the promise to give was reported.

Gains and Losses

13.12 Revenues are inflows of assets that result from an organization's ongoing major or central operations and activities. Gains are increases in net assets resulting from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from revenues. Expenses are outflows of assets or incurrences of liabilities that result from an organization's ongoing major or central operations

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[6] Paragraph 12.05 provides guidance concerning display of discounts.

and activities. Losses are decreases in net assets from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from expenses.

13.13 Gains and losses result both from an organization's peripheral or incidental activities and from events and circumstances that stem from the environment and that are largely beyond the control of a particular organization and its management. Some gains and losses result from holding assets or liabilities while their values change, such as from changes in the fair value of securities or changes in foreign exchange rates. Other gains and losses result from natural catastrophes, such as fires, floods, and earthquakes. Still others result from transactions (such as an organization's sale of buildings and equipment that are no longer needed for its ongoing operations, or from its winning or losing a lawsuit) that are only peripheral or incidental to the organization.

13.14 Transactions resulting in revenues for one not-for-profit organization may result in gains for another, which, in turn, determines how the related costs should be classified and displayed. Revenues and expenses are reported gross (except for investment revenues and related expenses, which are permitted to be reported net of related expenses, as discussed in paragraphs 8.08 and 13.23), while gains and losses may be reported net. Gains and losses should be reported as increases or decreases in unrestricted net assets unless their use is restricted by a donor or by law, in which case they should be reported as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate. Losses need not be reported by their functional classification or in the matrix that presents information about expenses according to both their functional and natural classifications.

Reporting Costs Related to Sales of Goods and Services

13.15 The way that costs related to sales of goods and services are displayed depends on whether the sales constitute a major or central activity of the organization or a peripheral or incidental activity. For example, a museum that has a store that is a major or central activity should report and display separately the revenues from the store's sales and the related cost of sales. Cost of sales is permitted to be reported immediately after revenues from sale of merchandise, and may be followed by a descriptive subtotal, or cost of sales may be reported with other expenses. If the store sells merchandise that is related to the museum's program, the store would be a program service and the cost of the store's sales would be reported as a program expense. In other circumstances, cost of sales could be reported as a separate supporting service. For example, if operating a cafeteria is a major or central activity but is not related to the organization's programs, the cafeteria's cost of sales would be reported as supporting services.

13.16 In contrast, a church that occasionally produces and sells a cookbook (considered to be a peripheral or incidental activity) has gains (or losses) from those sales, and the receipts and related costs are permitted to be offset and only the net gains (or losses) are reported. (These losses are not classified as an expense so they should not be reported by their functional classification.)

Reporting the Cost of Special Events and Other Fund-Raising Activities*

13.17 Some organizations conduct fund-raising activities, including special social and educational events (such as symposia, dinners, dances, and thea-

* See footnote 1.

ter parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

13.18 Organizations may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions. Alternatively, the organization could consider revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value) and report the two parts separately.

13.19 For example, assume an organization has a special event that is an ongoing and major activity with a ticket price of $100. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include administrative costs of $5 and fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.

13.20 Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		$200
Special event revenue	100	
Less: Costs of direct benefits to donors	(25)	
Net revenues from special events		75
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		25
Fund raising		30
Total other expenses		115
Increase in unrestricted net assets		$160

Illustration 2

Changes in unrestricted net assets:		
Revenues:		
Contributions	$200	
Special event revenue	100	
Total revenues		300
Expenses:		
Program	60	
Costs of direct benefits to donors	25	
Management and general	25	
Fund raising	30	
Total other expenses		140
Increase in unrestricted net assets	$160	

Illustration 3

Changes in unrestricted net assets:		
Contributions		$270
Dinner sales	30	
Less: Costs of direct benefits to donors	(25)	
Gross profit on special events		5
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		25
Fund raising		30
Total other expenses		115
Increase in unrestricted net assets		$160

13.21 Paragraphs 25 and 138 of FASB Statement No. 117 permit, but do not require, organizations to report receipts from special events that are peripheral or incidental activities net of related costs, without reporting those costs on the face of a statement of activities. Costs netted against receipts from peripheral or incidental special events should be limited to direct costs.

13.22 The frequency of the events and the significance of the gross revenues and expenses distinguish major or central events from peripheral or incidental events. Events are ongoing major and central activities if (*a*) they are normally part of an organization's strategy and it normally carries on such activities or (*b*) the event's gross revenues or expenses are significant in relation to the organization's annual budget. Events are peripheral or incidental if they are not an integral part of an organization's usual activities or if their gross revenues or expenses are not significant in relation to the organization's annual budget. Accordingly, similar events may be reported differently by different organizations based on the organization's overall activities.

Investment Revenues, Expenses, Gains, and Losses

13.23 Investment revenues may be reported net of related expenses, such as custodial costs and internal and external investment advisory costs, provided that the amount of such expenses is disclosed either on the face of a statement of activities or in notes to the financial statements. Expenses that are netted against investment revenues should, however, be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format (if the organization presents that statement). Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities. Chapter 8, "Investments," of this Guide, includes a more detailed discussion of investment gains and losses.

Functional Reporting of Expenses

13.24 As has been previously noted, FASB Statement No. 117 requires the presentation, in either a statement of activities or the notes to the financial statements, of information about expenses (but not losses) reported by their functional classification, such as major classes of program services and supporting activities. Program services are defined in paragraph 27 of FASB Statement No. 117 as "the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs." Program services may include cost of sales and costs of other revenue-generating activities that are program related. Supporting services are defined in paragraph 28 as "all activities of a not-for-profit organization other than program services. Generally, they include management and general, fund-raising, and membership-development activities." Supporting services may include, as one or more separate categories, cost of sales and costs of other revenue-generating activities that are not program related. FASB Statement No. 117 provides examples of the kinds of activities that fall into each of those categories, and further elaboration is provided in the following sections.

Functional Classifications

Program Services

13.25 The number of functional reporting classifications for program services varies according to the nature of the services rendered. For some organizations, a single functional reporting classification may be adequate to portray what may, in effect, be a single, integrated program service that the organization provides. In most cases, however, several separate and identifiable services are provided, and in such cases the expenses for program services should be reported by the kind of service function or group of functions. For example, a large university may have programs for student instruction, research, and public service, among others. A health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others. A federated fund-raising organization's programs may include making contributions to organizations supported by the federated fund-raising organization.

13.26 Paragraph 26 of FASB Statement No. 117 specifies that information about expenses should be reported by their functional classification, such as *major* classes of program services and supporting activities. For guidance on what constitutes *major* classes of programs and supporting activities, not-for-profit organizations may consider, among other sources, FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information.*[7]

13.27 The financial statements should provide information about program expenses. If the components of total program expenses are not evident from the details provided on the face of the statement of activities (for example, if cost of sales is not identified as either program or supporting services), the notes to the financial statements should disclose total program expenses and should provide information about why total program expenses disclosed in the notes does not articulate with the statement of activities. The financial statements should also provide a description of the nature of the organization's activities, including a description of each of its major classes of programs, either on the statement of activities (for example, using column headings) or in the notes to the financial statements.

Supporting Services

13.28 Not-for-profit organizations may have various kinds of supporting activities, such as management and general, fund raising, and membership development. Some industries have functional categories of supporting activities that are prevalent in that industry. For example, colleges and universities typically have institutional support and institutional development activities. A single functional reporting classification is ordinarily adequate to portray each kind of supporting service. Organizations may, however, present more detailed disaggregated information for each kind of supporting service. For example, fund-raising expenses and the corresponding support that is obtained may be reported separately for each kind of fund-raising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

13.29 *Management and general* activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general record keeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. The costs of oversight and management usually include the salaries and expenses of the governing board, the chief executive officer of the organization, and the supporting staff. (If such staff spend a portion of their time directly supervising program services or categories of other supporting services, however, their salaries and expenses should be allocated among those functions.) The costs of disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other costs, should similarly be classified as management and general expenses. The costs of soliciting funds other than contributions, including exchange transactions (whether program-related or not), should be classified as management and general expenses.

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[7] FASB Statement No. 131 applies only to public business enterprises; however, the Statement's guidelines may be helpful to not-for-profit organizations in determining the number of functional classifications that would be appropriate in their particular circumstances.

13.30* *Fund-raising activities* involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others. (Paragraph 13.49 discusses how fund-raising activities of federated fund-raising organizations should be reported.) The financial statements should disclose total fund-raising expenses.

13.31 Many not-for-profit organizations solicit financial support from the public through a variety of fund-raising activities, including direct mail, door-to-door canvassing, telephone solicitation, telethons, and special events. Some of the costs incurred by such organizations are clearly identifiable with fund-raising, such as the cost of fund-raising consulting services. However, organizations often incur joint costs, such as postage and other communication costs, in distributing materials or performing activities that relate to several functions, including program activities, fund-raising, or other supporting services. It is often difficult to distinguish the amounts of joint costs that relate to each function.

13.32 The guidance in paragraphs 13.33 through 13.40 applies only to joint costs of informational materials and activities that include a fund-raising appeal. Allocations of other joint costs are permitted under existing authoritative literature. Also, paragraphs 13.33 through 13.40 do not address the issue of how to allocate joint costs.[8] A number of cost accounting techniques are available for that purpose.

13.33 All joint costs of informational materials or activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds. However, if it can be demonstrated that a bona fide program or management and general function has been conducted in conjunction with the appeal for funds, joint costs should be allocated between fund-raising and the appropriate program or management and general function.

13.34 Demonstrating that a bona fide program or management and general function has been conducted in conjunction with an appeal for funds requires verifiable indications of the reasons for conducting the activity. Such indications include the content of the non-fund-raising portion of the activity; the audience targeted; the action, if any, requested of the recipients; and other corroborating evidence, such as written instructions to parties outside the organization who produce the activity, or documentation in minutes of the organization's board of the organization's reasons for the activity.

13.35 Most fund-raising appeals include descriptions of the causes for which the entities exist and the planned uses of the funds, to inform prospective donors why funds are needed and how they will be used. Unless an appeal is designed to motivate its audience to action other than providing financial support to the organization, all costs of the appeal should be charged to fund-raising.

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* See footnote 1.

[8] Paragraphs 13.42 through 13.46 of this Guide discuss classification of expenses related to more than one function.

13.36 In order to accomplish their basic missions, some organizations educate the public and seek the involvement of the public in the attainment of their missions by telling people what they can or should do about particular issues. Those organizations should allocate joint costs to program activities if the informational materials or activities further those program goals.

13.37 Two examples of situations in which it may be appropriate to allocate such joint costs to program activities follow:

a. A voluntary health and welfare organization describes the symptoms of a disease and the action an individual should take if those symptoms occur.

b. An organization whose purpose is to raise public awareness alerts individuals to a social or community problem and urges their action in seeking changes.

13.38 The content of the message is an important factor, but content alone may not be a conclusive indication of the reason for the activity. For example, if an audience is selected principally because of the organization's perception of its need for or interest in the educational information and not for its capacity to support the organization financially, any accompanying fund-raising appeal would appear to be incidental and the joint costs of the educational activity would not be required to be allocated. Conversely, if the audience is selected based on its presumed ability to provide financial support without consideration of its need for the educational information, the purpose would appear to be entirely fund-raising, and all joint costs should be considered fund-raising costs regardless of any accompanying educational message.

13.39 All circumstances surrounding informational materials and activities that include a fund-raising appeal should be examined, and the criteria in paragraphs 13.33 through 13.38 of this Guide should be applied together rather than separately.

13.40 Not-for-profit organizations incurring joint costs of informational materials and activities that include fund-raising appeals should disclose in their financial statements that such costs have been allocated, the total amount allocated during the period, and the portion allocated to each functional expense category. The following illustrates such disclosure.

Note X. Allocation of Joint Costs

In 19XX, the organization incurred joint costs of ______ for informational materials and activities that included fund-raising appeals. Of those costs, ______ was allocated to fund-raising expense, ______ was allocated to Program A expense, ______ was allocated to Program B expense, and ______ and was allocated to management and general expense.

13.41 *Membership-development activities* include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising, and the related costs should be reported as fund-raising costs. Membership development activities may be conducted in conjunction with other activities. The costs of activities that include membership development should be allocated to membership development and one or more other functions if the membership development activities are conducted in conjunction with other activities. For example, membership may entitle the members to group life and other insurance at reduced costs because of the organization's negotiated rates and to a subscription to the organization's magazine or newsletter; part of the membership dues may also represent a contribution.[9] Under these circumstances, an appropriate part of the costs of soliciting members should be allocated to the membership-development function, a part to program services, and a part to fund-raising activities.[10]

Classification of Expenses Related to More Than One Function

13.42 Some expenses are directly related to, and can be assigned to, a single major program or service or a single supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include salaries of persons who perform more than one kind of service and the rental of a building used for various programs and supporting activities.

13.43 Direct identification of specific expense (also referred to as *assigning* expenses) is the preferable method of charging expenses to various functions. If an expense can be specifically identified with a program or supporting service, it should be assigned to that function. For example, travel costs incurred in connection with a program activity should be assigned to that program.

13.44 If direct identification (that is, assignment) is impossible or impracticable, an allocation is appropriate. The techniques used to allocate are common to all entities, for-profit and not-for-profit alike. A reasonable allocation of expenses among an organization's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods.[11] The paragraphs that follow provide guidance (in addition to that presented throughout this chapter) on allocating or presenting certain costs that may be incurred by not-for-profit organizations.[12]

13.45 The allocation may be based on related financial or nonfinancial data. For example, the expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made. Occupying and maintaining a building is not a separate supporting service. Interest costs,[13] including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible; interest costs that cannot be allocated should be reported as part of the management and general function.

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[9] Paragraph 5.15 and Table 5.2 of this Guide provide indicators to help make these distinctions.

[10] Footnote 1 to this chapter describes guidance in this Guide and a proposed SOP that provide guidance on accounting for the costs of materials and activities that include a fund-raising appeal.

[11] Footnote 1 to this chapter describes guidance in this Guide and a proposed SOP that provide guidance on accounting for the costs of materials and activities that include a fund-raising appeal.

[12] The guidance found in U.S. Office of Management and Budget Circular A-122 may also be helpful in allocating costs.

[13] Paragraph 21 of FASB Statement No. 34, *Capitalization of Interest Cost*, requires disclosure of total interest costs incurred.

13.46 An organization should evaluate its expense allocation methods periodically. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the organization's current activities.

Support to Affiliated Organizations

13.47 Some organizations make payments or provide other support to local or national affiliates. The specific purposes and benefits of those payments may be determinable (for example, permission to raise funds in a specified geographical area, or the provision of joint purchasing arrangements and technical and fund-raising assistance, functions that the organization would otherwise have to carry out itself), or the purposes and benefits may be indeterminable. Payments in the form of grants and dues may also be made to affiliates.

13.48 Payments to affiliated organizations should be reported by their functional classification to the extent that it is practicable and reasonable to do so and the necessary information is available, even if it is impossible to allocate the entire amount of such payments to functions. Payments to affiliates that cannot be allocated to functions should be treated as a separate supporting service, reported on a statement of activities as a separate line item, and labeled "unallocated payments to affiliated organizations."

Expenses of Federated Fund-Raising Organizations

13.49 Federated fund-raising organizations solicit and receive designated and undesignated contributions and make grants and awards to other organizations. The fund-raising activities of these organizations, including activities related to fund-raising on behalf of others, should be reported as fund-raising expenses.

Income Taxes

13.50 If a not-for-profit organization incurs income tax expense, the notes to the financial statements should disclose the amount of the taxes and describe the nature of the activities that generated the taxes.

Auditing

13.51 Many audit objectives, controls, and auditing procedures for expenses, gains, and losses of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Expenses			
Presentation and disclosure	Expenses are properly classified and displayed.	Controls ensure that expenses are properly classified and displayed.	Compare current period expenses in total and by functional classification with expectations based on prior-period expenses and/or budget and obtain explanations for variances from expectations. Determine that expenses have been properly assigned and allocated to functional and, if applicable, natural classifications.

Chapter 14

Reports of Independent Auditors

Reports on Financial Statements

14.01 The guidance in Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), applies to auditors' reports on the financial statements of not-for-profit organizations.[1] The facts and circumstances of each particular audit will govern the appropriate form of report. This chapter discusses the application of SAS No. 58 to reports on the financial statements of not-for-profit organizations in specific circumstances.

14.02 The auditor's standard report described in SAS No. 58 refers to "results of operations," which is usually understood to refer to an enterprise's net income for a period together with other changes in net worth. As described in chapter 3, "Basic Financial Statements," of this Audit and Accounting Guide (Guide), a not-for-profit organization's statement of activities reports the changes in net assets[2] for the period but does not purport to present the results of operations, as would an income statement of a for-profit organization.[3] Accordingly, the opinion paragraph of the auditor's report should refer to "changes in net assets," since that is more descriptive of the information in the statement of activities than "results of operations." Auditors should not report separately on operations if the statement of activities includes an intermediate measure of operations.

Reports on Comparative Financial Statements

14.03 As noted in chapter 3 of this Guide, not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. If reporting on comparative financial statements, the auditor should consider paragraph 74 of SAS No. 58, which states the following:

> The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor should update his report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.

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[1] In December 1995, the Auditing Standards Board issued SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, which amends SAS No. 58 by eliminating the requirement that, when certain criteria are met, the auditor add an uncertainties paragraph to the auditor's report.

[2] As discussed in paragraph 3.08, descriptive terms such as "change in equity" may be used.

[3] As discussed in chapter 3 of this Guide, a not-for-profit organization may present an intermediate measure of operations within the statement of activities. As noted in chapter 3, however, if an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Such a statement would, therefore, ordinarily present more than merely the "results of operations"

Footnote 27 to paragraph 74 of SAS No. 58 states the following:

> A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units and not-for-profit organizations frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund, or the auditor would need to modify his report.

14.04 Though Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, does not require fund reporting, it does require, however, that certain basic information, such as reporting net assets and changes in net assets by net asset class, be provided. If the prior year(s) financial statements include the minimum information required by FASB Statement No. 117 and this Guide, the financial statements are not summarized information. Accordingly, the auditor should report on them.

14.05 As noted in paragraph 3.20, if the comparative financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this Guide—for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class—certain disclosures about the nature of the information presented are required. If the required disclosures about the nature of that information are omitted or are incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention. Such a paragraph might include the same wording that appears in the illustrative note presented as an example in paragraph 3.21 of this Guide. To reduce the likelihood that a reader might misinterpret such a paragraph to be a qualified opinion on the current period financial statements, the paragraph should follow the opinion paragraph and should not be referred to in either the scope or opinion paragraphs of the auditor's report.

Unqualified Opinions

14.06 The auditor's standard report contains an opinion that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). That conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). The form of the auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

We have audited the accompanying statement of financial position of XYZ Not-for-Profit Organization as of September 30, 19XX, and the related statements of activities and cash flows for the year then ended.[4] These financial

[4] Each of the statements presented, which may include a statement of functional expenses, should be identified in the introductory paragraph.

statements are the responsibility of XYZ Not-for-Profit Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 19XX, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Modified Reports and Departures From Unqualified Opinions

14.07 SAS No. 58, as amended by SAS No. 79, indicates the circumstances in which an explanatory paragraph should be added following the standard opinion paragraph for changes in accounting principles or in their method of application that have a material effect on the comparability of financial statements. The Statement also provides examples of auditors' reports in these circumstances. In addition, SAS No. 58 indicates circumstances in which departures from GAAP and limitations on the scope of the audit would require a qualified opinion, an adverse opinion, and a disclaimer of opinion, and provides examples of auditors' reports in those circumstances. Examples of possible departures from GAAP that an auditor of a not-for-profit organization's financial statements might encounter include the organization's failure to (*a*) recognize or appropriately measure promises to give, contributed services, or depreciation on plant and equipment in conformity with GAAP, and (*b*) provide information about expenses reported by their functional classification. The auditor's inability to obtain sufficient competent evidential matter to audit (*a*) contributed services that the organization has recorded or (*b*) receivables and revenues from fund-raising activities is an example of possible restrictions on the scope of the audit that an auditor of a not-for-profit organization's financial statements might encounter.

14.08 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended by SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as Going Concern, *and No. 62,* Special Reports, indicates circumstances in which an explanatory paragraph should be added following the standard opinion paragraph because the auditor has substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. SAS No. 59 also provides guidance on reporting in that situation, including an example of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern. Paragraph 2.47 of this Guide contains examples of conditions or events that are particularly applicable to not-for-profit organizations and that might indicate that there could be substantial doubt about the organization's continued existence.

Reporting on Supplementary Information

14.09 Footnote 6 to paragraph 27 of FASB Statement No. 117 states the following:

> Information about an organization's major programs (or segments) can be enhanced by reporting the interrelationships of program expenses and program revenues.... Related nonmonetary information about program inputs, outputs, and results also is helpful.... Generally, reporting that kind of information is feasible only in supplementary information or management explanations or by other methods of financial reporting.

14.10 Although nonmonetary information about an organization's activities and programs may be informative and helpful to users of the financial statements, this information is not necessary for fair presentation of financial position, changes in net assets, or cash flows on which the auditor is reporting. In addition, this information may not be auditable if it is obtained from records outside the accounting system that are not subject to controls, rather than being obtained (or derived by analysis or computation) from records subject to controls. Accordingly, this information should not be included in the financial statements (including the related notes) unless it is obtained from the organization's accounting records that are subject to controls over the organization's accounting system or derived directly from such accounting records by analysis or computation. Paragraph 46 of SAS No. 58 suggests that if information that is not audited and is not necessary for a fair presentation is included in the financial statements (including the related notes), such information may be identified as *unaudited* or *as not covered by the auditor's report*, in which case the auditor should not comment on it or otherwise be associated with it.

Bases of Accounting Other Than GAAP

14.11 Some not-for-profit organizations may find that financial statements prepared on the cash basis or the modified cash basis of accounting are adequate for their governing boards and other users. SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), describes the auditor's reporting requirements when the financial statements are prepared on a comprehensive basis of accounting other than GAAP (OCBOA), including the cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support.[5]

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[5] The accrual basis of accounting is required by GAAP for a fair presentation of financial position, changes in net assets, and cash flows. Financial statements presented on the cash receipts and disbursements basis of accounting or using modifications of the cash basis having substantial support may be considered to present financial position, changes in net assets, and cash flows in conformity with GAAP only if they do not differ materially from financial statements prepared on an accrual basis.

14.12 SAS No. 62 also permits an auditor to issue a special report on financial statements that have been prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency but that do not conform with GAAP or constitute OCBOA. In that instance, the auditor's report should include a paragraph that restricts the distribution of the report solely to persons within the organization and for filing with the regulatory agency. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. The auditor may use this form of report, however, only if the financial statements and report are intended solely for filing with the regulatory agency to whose jurisdiction the organization is subject.

Reporting on Prescribed Forms

14.13 Some not-for-profit organizations prepare financial reports using forms prescribed by an affiliated organization. The auditor should review these forms and any accompanying preprinted auditor's report for compliance with GAAP and GAAS. If the financial statements prepared using the prescribed form do not conform with GAAP, either the auditor can attach a separate set of financial statements and report on them, or he or she can issue a report on the prescribed form but include a restriction on its distribution, as discussed above. If the auditor considers the preprinted auditor's report inappropriate, he or she should prepare a separate report. When a separate report is used, the auditor should consider inserting language such as "See attached independent auditor's report" in the space provided for the auditor's signature on the preprinted form.

14.14 Internal Revenue Service (IRS) Form 990, *Return of Organizations Exempt from Income Tax*, may be used in some states as an annual report by not-for-profit organizations for reporting to both state and federal governments. Many states require an auditor's opinion on the financial statements included in an IRS Form 990. An auditing interpretation of SAS No. 62 titled "Reports on the Financial Statements Included in Internal Revenue Form 990, 'Return of Organizations Exempt from Income Tax'" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.47–.54), provides guidance on reporting on financial statements included in Form 990. (Paragraph 54 of that Interpretation may no longer be relevant as a result of the issuance of FASB Statement Nos. 116 and 117.)

Reports Required by *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and OMB Circular A-133

14.15 *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and U.S. Office of Management and Budget (OMB) Circular A-133 broaden the auditor's responsibility to include reporting on not only an organization's financial statements but also its internal control and its compliance with laws and regulations. Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*,[6] describes and illustrates the required reports.

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[6] SOP 98-3 is included as appendix D of this Guide (see footnotes 2 and 9 in chapter 2 of this Guide).

Chapter 15
Tax Considerations

Introduction

15.01 This chapter discusses certain tax considerations relevant to not-for-profit organizations. It does not contain a detailed discussion of the Internal Revenue Code (IRC) and of rulings that have been issued by the Internal Revenue Service (IRS) and that apply to not-for-profit organizations, nor is it intended as a substitute for appropriate research in resolving tax issues.

15.02 Not-for-profit organizations and their auditors should be aware of relevant federal and state tax laws and regulations and their potential impact on the organization and its financial statements. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may, as discussed in chapter 2, "General Auditing Considerations," of this Audit and Accounting Guide (Guide), have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status).

Basis of Exemption

15.03 The IRS determines whether an organization qualifies for exemption from federal income tax. The following are some of the more common types of tax-exempt organizations:

- Corporations, united funds, other funds, and foundations organized and operated (*a*) exclusively for religious, charitable, scientific, testing-for-public-safety, literary, or educational purposes, (*b*) to foster national or international amateur sports competition, or (*c*) for the prevention of cruelty to children or animals
- Civic leagues, organizations operated exclusively for the promotion of social welfare, and certain local associations of employees
- Labor, agricultural, and horticultural organizations
- Business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues, that are not organized for profit
- Clubs organized for pleasure, recreation, and other not-for-profit purposes

15.04 Exemptions from state and local sales, real estate, and other taxes vary from state to state. Organizations are generally subject to the laws of the state of incorporation as well as the laws of states in which they conduct significant activities. Each state's laws govern exemption from its taxes and should be consulted for the applicable definitions and requirements.

15.05 Tax exemption is a privilege and not a right. At the federal level, the IRS has the authority to revoke exemptions for any one of several reasons. Furthermore, individual states have regulatory bodies that oversee not-for-profit organizations and that can revoke their state tax-exempt status without regard to their federal tax-exempt status and even prevent them from operating. There are many potential threats to an organization's federal tax-exempt status, of which the following are particularly important:

- Material changes in the organization's character, purpose, or method of operation
- Private inurement
- Private benefit
- Commerciality
- Lobbying
- Political campaign activities
- Unrelated business income
- Failure of the organization to meet the commensurate test
- Violation of public policy by the organization

15.06 The IRS requires that organizations disclose on Form 990 any changes in the kinds of exempt activities the organization conducts, any changes in its governing documents, and whether there has been a liquidation, dissolution, or substantial contraction. If there has been a material change in the organization's character, purpose, or method of operation, it may be appropriate to seek IRS guidance in the form of a private letter ruling.

15.07 Not-for-profit organizations are generally prohibited from making distributions to those who control or support them financially. IRS rules regulate transactions between a not-for-profit organization and insiders. IRC provisions concerning such transactions are stricter for private foundations than for other not-for-profit organizations. Insiders are individuals with a personal or private interest in the organization, such as governing board members, officers, certain employees, and substantial contributors. Transactions between insiders and not-for-profit organizations are permitted, but the organization has the burden of proving that the transactions do not result in private inurement. The organization must be able to satisfy the IRS that the transaction was reasonable, was adequately documented, had independent approval, and did not violate any law or regulation. Employee compensation can create an inurement problem if it is judged to be "unreasonably high."

15.08 The concept of private benefit prohibits a not-for-profit organization from providing excessive benefits for the private interests of any specific individual or group—both insiders and outsiders. Incidental levels of private benefits are permitted, but the organization is required to demonstrate that such benefits are a necessary concomitant of a public related benefit. The organization should have sound policies for transactions with both insiders and outsiders, and these policies should document that the transactions were appropriate and were approved by disinterested parties.

15.09 A not-for-profit organization cannot qualify for tax exemption, or can have its tax-exempt status revoked, if it is, in reality, a commercial enterprise. Engaging in commercial activity, however, does not *per se* disqualify the organization from tax-exempt status unless the commercial activity becomes the organization's primary purpose. A gray area exists between commercial and noncommercial activities. To avoid problems with commerciality, many not-for-profit organizations have found it advantageous to create separate for-profit subsidiaries.

15.10 The IRC allows public charities (but not private foundations) to lobby to influence federal, state, and local legislation (including initiatives and referenda), but it places limits on how much lobbying they can do. Membership organizations that are granted tax-exempt status under IRC Section 501(c)(4)(5) or (6) and lobby are required to make complex disclosures to their members or pay a proxy tax.

15.11 Public charities are prohibited from engaging in partisan political campaign activities. Prohibited political activities include contributing to candidates or political organizations, including, for example, in-kind contributions of services, publicity, advertising, paid staff time, facilities, and office space. Also prohibited are evaluating candidates and their positions on specific issues and encouraging voter registration for a specific political group. Permitted political activities include nonpartisan get-out-the-vote campaigns.

15.12 Not-for-profit organizations can lose their tax-exempt status if the IRS determines that too large a percentage of their income is from business activities unrelated to their specific exempt purposes. There is, however, no specific percentage of unrelated business income that can be designated as too large a percentage and is, therefore, not permissible. The facts and circumstances of each unrelated business income situation should be considered. Unrelated business income and the unrelated business income tax are discussed in more detail in paragraphs 15.17 through 15.19.

15.13 A not-for-profit organization can lose its tax-exempt status if it fails the commensurate test, which provides that the scope of the organization's programs must be commensurate with its financial resources. The test requires that an organization have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial. This means that fund-raising expenses and administrative expenses should not be an excessive percentage of total expenses. Although no specific payout percentage has been established and individual facts and circumstances must be considered, low levels of program spending invite IRS scrutiny.

15.14 An organization can also lose its tax exemption because it violates public policy, for example, through racial discrimination.

Federal and State Filing Requirements

15.15 Most tax-exempt organizations, except those with less than $25,000 in gross receipts or churches, must file annual information returns with the IRS. Most states also have their own registration and filing requirements, some of which include audited financial statements. The auditor should be aware of specific state laws and regulations that specify filing and reporting requirements, but except for the discussion of related auditors' reports in chapter 14, "Reports of Independent Auditors," of this Guide, these are beyond the scope of this Guide.

Public Charities and Private Foundations

15.16 The IRS considers all charitable organizations (that is, those that are tax-exempt under IRC Section 501(c)(3)) to be private foundations unless they qualify as public charities (sometimes referred to as *nonprivate foundations*) under one of several IRC tests. Private foundations are subject to more restrictions under the tax law than are public charities. These restrictions include statutory prohibitions against self-dealing, excess business holdings, jeopardy investments, and taxable expenditures. In addition, private foundations are subject to an excise tax on their net investment income and are required to make annual distributions of five percent of the average market value of their noncharitable-use assets for charitable, educational, scientific, and similar purposes. (Noncharitable-use assets are assets that are not used or held for use directly in carrying on the organization's exempt purpose; they include assets held for investment and the production of investment income.) Private foundations are also required to publish annually a notice that their annual reports are available for inspection. Public charities are exempt from federal unemployment taxes. Both public charities and private foundations may be exempt from property and sales taxes in some states.

Unrelated Business Income

15.17 Unrelated business income is gross income from an unrelated trade or business less expenses "directly connected" with the unrelated trade or business, certain net operating losses, and qualified charitable contributions. An unrelated trade or business of an exempt organization is any trade or business which is regularly carried on, and whose conduct is not substantially related to the exercise or performance of its exempt purpose. The IRS is primarily interested in how the unrelated business income was earned, not in how it is used, even if it is used to further the organization's tax-exempt purpose. Unrelated business income is subject to federal corporate taxes on income, including the alternative minimum tax (AMT). (The first $1,000 of net unrelated business income is excluded from taxation, and corporate net operating losses and various tax credits are allowed.)

15.18 The unrelated-business-income tax requirements apply to all not-for-profit organizations except (*a*) corporations that have been organized under Acts of Congress and that are instrumentalities of the United States and (*b*) certain charitable trusts not subject to the tax on private foundations.

15.19 Income from certain specified activities that might otherwise be considered unrelated business income is excluded from taxation. For example, unrelated business income does not include dividends, interest, royalties, and gains on the sale of property (unless that property was used in an unrelated trade or business). Unrelated business income also does not include income from activities in which substantially all of the work is done by volunteers, income from the sale of donated merchandise, and rents from real property. However, rents from debt-financed property, rents based on a percentage of net income rather than gross income, and rents on personal property are considered to be unrelated business income.

Auditing

15.20 As previously discussed, noncompliance with federal and state tax laws and regulations may have direct and material effects on an organization's financial statements. Noncompliance may also, possibly through the loss of the organization's tax-exempt status, have indirect effects on the statements. Since many organizations depend on their tax-exempt status for funding purposes and could lose their funding if that status was revoked, such indirect effects may also indicate that there is substantial doubt about the organization's ability to continue as a going concern.

15.21 Many audit objectives, controls, and auditing procedures for the tax provisions and liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

Auditing Considerations

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
Rights and obligations	The not-for-profit organization has obtained qualifying tax exemptions from the appropriate government authorities.	Management monitors compliance with applicable tax regulations.	Ascertain whether the organization has been granted tax-exempt status. Review minutes of governing board meetings for changes in the organization's governing instruments that could affect its tax-exempt status. Consider the effect of new, expanded, or unusual activities on the organization's tax-exempt status.
Completeness	All liabilities and contingencies for taxes due for the current and prior years are accrued or disclosed.	Tax returns are prepared and reviewed by knowledgeable personnel.	Inquire if tax returns have been filed on a timely basis. Review tax returns or filings and related correspondence for all "open" years. Review revenue agent's reports, if any, for evidence of additional liabilities or contingencies.

Financial Statement Assertions	*Specific Audit Objectives*	*Examples of Selected Controls*	*Examples of Auditing Procedures*
			Review minutes of governing board and governing board committee meetings and the accounting records for evidence of significant unrelated business income.
			Review the reasonableness of the computation of any unrelated business income tax liability.
Presentation and disclosure	The organization's tax-exempt status and any tax contingencies are disclosed in the notes to the financial statements.		Determine whether the organization's tax-exempt status and any tax contingencies are appropriately disclosed in the notes to the financial statements.

Chapter 16

Fund Accounting

Introduction

16.01 Many not-for-profit organizations have used fund accounting both for internal recordkeeping and for external financial reporting purposes. Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities associated with specific activities, donor-imposed restrictions, or objectives. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, however, establishes a financial reporting model based on net assets, classified solely on the basis of donor-imposed restrictions, and requires not-for-profit organizations' external financial reporting to focus on aggregate information about the entity as a whole, rather than on individual funds.[1] Though fund accounting is not required by generally accepted accounting principles, some entities will continue to use fund accounting for internal recordkeeping purposes. Also, FASB Statement No. 117 and this Audit and Accounting Guide (Guide) permit the continued disclosure, for external financial reporting purposes, of disaggregated data classified by fund groups, provided that the information required by FASB Statement No. 117 and this Guide is presented. This chapter provides an overview of fund accounting and discusses the reporting of information derived from an internal fund accounting system in conformity with the reporting requirements of the net asset model.[2, 3]

Fund Accounting and External Financial Reporting

16.02 Fund accounting is a system of recording resources whose use may be limited by donors, granting agencies, governing boards, or other individuals or entities or by law. To keep records of these limitations for internal purposes, some not-for-profit organizations maintain separate funds for specific purposes. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts. Before the issuance of FASB Statement No. 117, most not-for-profit organizations prepared fund-accounting-based external financial statements by combining funds with similar characteristics into fund groups. Authoritative guidance for external financial reporting was provided by the two AICPA industry audit guides, one audit and accounting guide, and two of the Statements of Position (SOPs) that are superseded by this Guide.[4]

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[1] Both fund balances and net assets represent residual interests in assets less liabilities. Fund balances, however, are not the same as net asset balances.

[2] The discussion in this chapter assumes that the provisions of paragraph 17 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, concerning the recognition of expirations of donor-imposed restrictions are applied prospectively, in conformity with paragraph 30 of Statement No. 116.

[3] The timing of recognition of changes in net assets under fund accounting and the net asset model may differ. For example, restrictions may expire under the net asset model in different periods than when expenses are reported in a fund. Accordingly, not-for-profit organizations that continue to use fund accounting for internal recordkeeping purposes should keep records of all transactions and events that have been recognized under one model but not the other and should adjust opening fund accounting balances to amounts representing opening net assets.

[4] As noted in the preface, this Guide supersedes *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities* (including SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*) and *Audits of Certain Nonprofit Organizations* (including SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*).

16.03 For external financial reporting purposes, the total of all assets and liabilities included in all funds and changes in net assets should be measured and reported on a not-for-profit organization's financial statements in conformity with FASB Statement Nos. 116 and 117 and with chapters 3 through 13 of this Guide. (As stated in footnote 8 of Statement No. 117, "because receivables and payables between fund groups are not organizational assets or liabilities, a statement of financial position must clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities.") Fund balances should be classified on a statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the existence and type of donor-imposed restrictions.[5] For external financial reporting purposes, a fund balance may have to be divided among more than one net asset class. The remainder of this chapter describes seven commonly used kinds of funds and discusses how their fund balances should be reported based on the requirements of FASB Statement No. 117 and this Guide.

Unrestricted Current (or Unrestricted Operating or General) Funds

16.04 Unrestricted current funds (also called *unrestricted operating* or *general* funds) are used to record organizations' activities that are supported by resources over which governing boards have discretionary control. Amounts designated by governing boards for specific purposes may be included in unrestricted current funds, or those amounts may be accounted for in other funds, such as plant funds, endowment funds, and loan funds. The principal sources of unrestricted current funds are unrestricted contributions from donors; exchange transactions with members, clients, students, customers, and others; and unrestricted investment income. Resources are used to help meet the costs of providing the organization's programs and supporting services.

16.05 Fund balances of unrestricted current funds should be classified on a statement of financial position as unrestricted net assets unless donors have stipulated restrictions on the use of contributed assets that expire by passage of time. In those situations, net assets should be classified as temporarily restricted. Unrestricted fund balances that have been designated by governing bodies for specific purposes (such as *quasi-endowment*, *funds functioning as endowment*, *funds for long-term investment*, *self-insurance reserve funds*, or *future development funds*) should be classified as unrestricted net assets. Board designations are permitted to be disclosed, as discussed in paragraphs 3.07 and 11.12 of this Guide.

Restricted Current (or Restricted Operating or Specific-Purpose) Funds

16.06 Restricted current funds (also called *restricted operating* or *specific-purpose* funds) are used to record organizations' activities that are supported by resources whose use is limited by external parties to specific operating purposes. The principal sources of restricted current funds are contributions

[5] Accounting for contributions received with donor-imposed restrictions is discussed in paragraphs 5.26 through 5.34 of this Guide.

from donors; contracts, grants and appropriations; endowment income; and other sources where resource providers have stipulated the specific operating purposes for which the resources are to be used.

16.07 Fund balances of restricted current funds represent net assets held for specified operating activities that have not yet been used. The portion of the fund balances, if any, that represents amounts contributed with donor-imposed restrictions should be classified as temporarily restricted net assets. Fund balances representing amounts received with limitations other than donor-imposed restrictions, such as contractual limitations, should be classified as unrestricted net assets. Any portion of the fund balances that represents unearned revenue resulting from exchange transactions should be classified as a liability.

Plant (or Land, Building, and Equipment) Funds

16.08 Some not-for-profit organizations record plant and equipment (and resources held to acquire them) in a plant (or land, building, and equipment) fund or funds. A plant fund may be a single group of accounts or may be subdivided into some or all of the following subfund account groups:

- Unexpended plant funds
- Funds for renewal and replacement
- Funds for retirement of indebtedness
- Investment (or net investment) in plant

16.09 Unexpended plant fund balances and renewals and replacement fund balances represent net assets that have not yet been used to acquire, renew, and replace plant and equipment. Retirement-of-indebtedness fund balances represent net assets held to service debt related to the acquisition or construction of plant and equipment. The portion of those fund balances that represents amounts received with donor-imposed restrictions should be classified in a statement of financial position as temporarily restricted or permanently restricted net assets, depending on the nature of the restrictions. Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the organization's governing board for the purchase, construction, renewal, or replacement of property and equipment, should be classified as unrestricted net assets.[6]

16.10 Investment-in-plant fund balances represent assets invested in property and equipment less any liabilities related to those assets. These fund balances should be classified as permanently restricted net assets to the extent that (1) donors have imposed restrictions on the assets' use that neither expire by passage of time nor can be fulfilled or removed by actions of the organization—for example, land that must be held in perpetuity—or (2) the proceeds from the ultimate sale or disposal of contributed assets must be reinvested in perpetuity. Amounts representing property and equipment donated or acquired with donor-imposed restrictions that expire by passage of time or that can be fulfilled or removed by actions of the organization should be classified as temporarily restricted net assets. Amounts representing gifts of property and equipment received without donor-imposed restrictions about how long the

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[6] Board designations and other limitations on the use of unrestricted net assets stipulated by entities other than donors can be described on the face of the financial statements or in the notes. Paragraphs 3.07 and 11.12 of this Guide discuss such disclosures.

assets must be used should be classified as either unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.[7] Amounts representing property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors should be classified as unrestricted net assets. Significant limitations on the use of property and equipment should be described in notes to the financial statements.[8]

Loan Funds

16.11 Some not-for-profit organizations use loan funds to account for loans made to students, employees, and other constituents and resources available for those purposes. The assets initially made available for the loans may be provided by donors or various governmental and other granting agencies or designated by governing boards. These organizations or individuals may also stipulate qualifications for individual borrowers. Some loan funds are self-perpetuating—that is, the principal and interest repayments on outstanding loans are used to make additional loans. Other loan funds are created on a temporary basis, and the original resource providers must be repaid. In some situations, repayments may be forgiven by resource providers if certain conditions are met.

16.12 Fund balances of loan funds represent net assets available for lending. The portion of the fund balances representing net assets restricted by donors in perpetuity for use in making loans (for example, a revolving fund) should be classified as permanently restricted. The portion of the fund balances representing net assets temporarily restricted by donors (for example, if, each year, a portion of the fund may be used for the unrestricted purposes of the organization) should be classified as temporarily restricted. Amounts that have been designated by governing boards to be used as loan funds, such as amounts designated as matching funds for government loan programs (for example, government loans to students that require colleges and universities to match a portion of those loans) and other amounts used for loans that have not been restricted by donors, should be classified as unrestricted net assets. Any portion of loan fund balances that represents refundable advances, such as under a government loan program, should be reported as a liability.

Endowment Funds

16.13 Some not-for-profit organizations record cash, securities, or other assets held to provide income for the maintenance of the organization in an endowment fund or funds. Three kinds of endowment may be identified: permanent endowment; term endowment; and quasi endowment, or funds functioning as endowment. *Permanent endowment* refers to amounts that have been contributed with donor-specified restrictions that the principal be invested in perpetuity; income from those investments may also be restricted by donors. *Term endowment* is similar to permanent endowment, except that at some future time or upon the occurrence of a specified future event, the re-

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[7] Paragraph 9.05 of this Guide discusses alternative accounting policies concerning the contribution of long-lived assets received without donor-imposed restrictions.

[8] Examples of significant limitations on the use of property and equipment that should be described in the notes to the financial statements are provided in paragraph 9.15 of this Guide.

sources originally contributed become available for unrestricted or purpose-restricted use by the entity. *Quasi endowment* refers to resources designated by an entity's governing board to be retained and invested for specified purposes for a long but unspecified period.

16.14 Fund balances of endowment funds represent net assets for which various limitations exist on the use of the resources invested and, in some cases, on the income generated by those resources. Amounts that represent net assets restricted by donors in perpetuity should be classified as permanently restricted. If donor-imposed restrictions exist that preclude the use of gains and losses (net appreciation) on permanent endowment, either as a result of explicit or implicit donor stipulation or by the organization's interpretation of the relevant law, those gains and losses should also be classified as permanently restricted. In the absence of such restrictions, those gains and losses should be classified as temporarily restricted or unrestricted, depending on the existence or absence of temporary restrictions imposed by the donor.

16.15 Fund balances that represent term endowments for which the principal must be maintained for a specific period or must be used at the end of the term for a specified purpose should be classified as temporarily restricted net assets. Amounts representing resources that will be permanently restricted at the end of a specified term should be classified as permanently restricted net assets.

16.16 Fund balances that represent quasi endowments or other amounts designated by the organization's governing board should be classified as unrestricted net assets unless donor-imposed restrictions exist on their use. Board designations are permitted to be disclosed, as discussed in paragraphs 3.07 and 11.12 of this Guide.

Annuity and Life-Income (Split-Interest) Funds

16.17 Annuity and life-income (or split-interest) funds may be used by not-for-profit organizations to account for resources provided by donors under various kinds of agreements in which the organization has a beneficial interest in the resources but is not the sole beneficiary. These agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Split-interest agreements are discussed in chapter 6, "Split-Interest Agreements," of this Guide.

16.18 Fund balances of annuity and life-income funds represent a not-for-profit organization's beneficial interest in the resources contributed by donors under split-interest agreements. Any portion of the fund balances representing amounts that will become part of permanent endowment when the agreements terminate should be classified as permanently restricted net assets. Any portion of the fund balances representing amounts that will be available for restricted purposes, or available for unrestricted use, by the entity when agreements terminate should be classified as temporarily restricted net assets. Any portion of the fund balances representing amounts that are available for unrestricted purposes should be classified as unrestricted net assets.

Agency (Or Custodian) Funds

16.19 Agency (or custodian) funds are used by not-for-profit organizations to account for resources held by the entity as an agent for resource providers before those resources are transferred to third-party recipients specified by the resource providers. The entity has little or no discretion over the use of those resources. Accounting for agency transactions and distinguishing agency transactions from contributions are discussed in chapter 5, "Contributions Received and Agency Transactions," of this Guide. Because the assets and liabilities are always equal in agency funds, no net assets are reported.

Summary

16.20 The following exhibit summarizes the net asset classes into which various kinds of fund balances will typically be classified.

Typical Classification of Fund Balances

	Net Asset Class		
Fund Type	*Permanently Restricted*	*Temporarily Restricted*	*Unrestricted*
Unrestricted Current (or Unrestricted Operating or General)	Not applicable	Contributions with donor-imposed restrictions that expire with the passage of time (not usually present in unrestricted current funds)	Unrestricted fund balances, including those designated by governing bodies for specific purposes
Restricted Current (or Restricted Operating or Specific Purpose)	Not applicable	Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization	Unrestricted fund balances, including those designated by governing bodies for specific purposes[9]
Plant (or Land, Building, and Equipment)	Contributions with donor-imposed restrictions that do not expire with the passage of time or cannot be fulfilled or removed by actions of the organization[10]	Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization[11]	Unrestricted fund balances, including those designated by governing bodies for specific purposes[12]

[9] Any portion of the fund balances representing unearned revenue from exchange transactions should be classified as a liability.

[10] This would include contributed assets such as land and capitalized collection items that must be held in perpetuity and other contributed assets when donors have stipulated that the proceeds from their ultimate sale or disposal must be reinvested in perpetuity.

[11] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

[12] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

Fund Type	*Permanently Restricted*	*Temporarily Restricted*	*Unrestricted*
Loan	Contributions with donor-imposed restrictions that do not expire with the passage of time or can not be fulfilled or removed by actions of the organization	Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization	Unrestricted fund balances, including those designated by governing bodies for specific purposes
Endowment	Permanent endowment[13]	Temporary (or term) endowment[14]	Quasi endowment[15]
Annuity and Life-Income (Split Interests)	Donor-restricted in perpetuity	Amounts available for unrestricted or time-or-purpose restricted use when agreement terminates	Unrestricted fund balances, including those designated by governing bodies for specific purposes
Agency (or Custodian)	Not applicable	Not applicable	Not applicable

[13] Includes gains and losses on permanent endowment when donor restrictions or law permanently preclude their use.

[14] Includes gains on permanent endowment when donor restrictions or law specify their use.

[15] Includes gains on permanent endowment when donors or laws do not restrict or specify their use.

Appendix A

Background Information and Basis for Conclusions

1. This appendix provides background information and discusses the comments received on the April 14, 1995, exposure draft that preceded this Audit and Accounting Guide (Guide)—Proposed Audit and Accounting Guide *Not-for-Profit Organizations*—and the basis for key conclusions in this Guide.

Background

2. In June 1993, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, and Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. At the time those Statement were issued, guidance on accounting and reporting by not-for-profit organizations was provided by the following AICPA pronouncements:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*, including Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*, including SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Some of the guidance in those AICPA pronouncements was inconsistent with FASB Statement Nos. 116 and 117.

3. In light of the comprehensive changes in generally accepted accounting principles (GAAP) for not-for-profit organizations resulting from guidance in FASB Statement Nos. 116 and 117, as well as changes in practice that have occurred subsequent to the issuance of the pronouncements that this Guide supersedes, the AICPA's Accounting Standards Executive Committee (AcSEC) and the Not-for-Profit Organizations Committee (the Committees) concluded that the AICPA guidance should be completely rewritten, rather than merely revised for conforming changes based on the issuance of Statement Nos. 116 and 117.

4. FASB Statement Nos. 116 and 117 provide broad, rather than industry-specific, guidance for the various kinds of not-for-profit organizations. By providing broad guidance directed at critical issues, FASB Statement Nos. 116 and 117 allow organizations latitude to report relevant information in ways they believe are most useful to financial statements users. Paragraphs 3 and 49 of FASB Statement No. 117 specify that, within the parameters of that Statement, the AICPA may provide more specific reporting guidance for certain not-for-profit organizations.

5. In light of the broad standards included in FASB Statement Nos. 116 and 117 and the belief that like transactions should be accounted for in like ways, regardless of the industry in which the organization operates, the Committees believe that this Guide should apply to all not-for-profit organiza-

tions. Further, this Guide should include guidance that is applied consistently by different kinds of not-for-profit organizations, rather than guidance that differs based on the kind of not-for-profit organization, such as voluntary health and welfare organizations or private colleges and universities.[1] Accordingly, this Guide is directed at not-for-profit organizations in general and not at specific kinds of such organizations.

Discussion of Comment Letters and Basis for Conclusions

6. In April 1995, the Committees released an exposure draft of a proposed Audit and Accounting Guide *Not-for-Profit Organizations* for public comment. The Committees received 160 comment letters on the exposure draft. The Committees redeliberated the issues based on the comments received. The following is a discussion of the key issues in the exposure draft and comments received on those issues, as well as the basis for the Committees' conclusions on those and certain other issues.

Scope

7. The exposure draft proposed that some organizations that have traditionally been considered to be not-for-profit organizations do not meet the definition of a not-for-profit organization in FASB Statement No. 116. The exposure draft noted that, though FASB Statement No. 117 excludes those organizations from its scope, it contains broad guidelines that would enable them to prepare meaningful financial statements. Accordingly, the exposure draft proposed that, with certain limited exceptions, the Guide apply to nongovernmental organizations of the kinds that have traditionally been considered to be not-for-profit organizations, such as certain social clubs and trade associations, unless they are organized for for-profit purposes, regardless of whether a particular organization meets the definition of a not-for-profit organization in FASB Statement No. 116. Also, the exposure draft noted that certain FASB and other pronouncements apply to organizations other than those that meet the FASB Statement No. 116 definition of a not-for-profit organization (those pronouncements exempt not-for-profit organizations). Accordingly, the exposure draft noted that organizations that do not meet the FASB Statement No. 116 definition of a not-for-profit organization, regardless of whether they are within the scope of this Guide, are required to follow GAAP applicable to for-profit entities, such as FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Some respondents commented that the Guide should revise or clarify the definition of a not-for-profit organization. The Committees believe that the intent of the FASB in drafting the definition in Statement No. 116 was that the term *not-for-profit organizations* encompasses all entities defined as *not-for-profit organizations* by FASB Statement No. 116, including the kinds of organizations that were

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[1] At the same time that AcSEC undertook this project, AcSEC and the Health Care Committee undertook a project to revise the Audit and Accounting Guide *Audits of Providers of Health Care Services*. The guidance in that revised Guide, *Health Care Organizations*, applies to health care providers that are not-for-profit organizations, as well as to for-profit and governmental health care providers. AcSEC believes that comparability among health care providers is more important than comparability between not-for-profit health care providers and other kinds of not-for-profit organizations. Accordingly, this Guide does not include guidance for not-for-profit health care providers. However, the guidance in *Health Care Organizations* for not-for-profit health care organizations is similar to the guidance in this Guide for other not-for-profit organizations, unless differences are justified for purposes of comparability among health care providers.

covered by the AICPA pronouncements that are superseded by this Guide. Further, the Committees believe that the guidance proposed in the exposure draft could create practice problems for entities for which it may be unclear whether they meet that definition. Accordingly, the Guide has been revised to provide that the term *not-for-profit organizations* includes the kinds of organizations that were covered by the AICPA pronouncements that are superseded by this Guide.

Nongovernmental Not-for-Profit Organizations

8. As noted in paragraph 7 of this appendix, the exposure draft proposed that the Guide apply to certain kinds of nongovernmental organizations. However, the exposure draft did not define *nongovernmental* and did not include guidance to help identify nongovernmental organizations. Some respondents commented that the Guide should define *nongovernmental.* They pointed out that AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411), establishes separate hierarchies of sources of GAAP for nongovernmental and governmental entities and that there is diversity in practice concerning how entities are determined to be *nongovernmental.*

9. Subsequent to the release of the exposure draft, during a public meeting in which they cleared the proposed Audit and Accounting Guide *Health Care Organizations* for final issuance, the FASB and the Governmental Accounting Standards Board agreed on the definition of a *government.* Accordingly, this Guide incorporates that definition and defines *nongovernment entities* as all entities not meeting the definition of a *government.*

GAAP Hierarchy

10. Paragraph 1.12 of the Guide states that not-for-profit organizations should follow the display guidance in FASB Statement No. 117 and this Guide, even though that guidance may conflict with display that would result from applying the guidance in certain pronouncements included in appendix D [paragraph 1.27] of chapter 1, "Introduction," of this Guide. (The guidance in appendix D [paragraph 1.27] is included in category (a) of the GAAP hierarchy and is a higher category of GAAP than this Guide, as discussed in appendix G [paragraph 1.30] of chapter 1.) Paragraph 1.12 does not imply that guidance in this Guide is a higher category of GAAP than guidance in category (a). Paragraph 1.12 merely addresses the fact that not-for-profit organizations use a financial reporting display model that differs from the model used by for-profit entities and that the not-for-profit model may not have been contemplated in developing the guidance in some category (a) pronouncements.

Operations

11. The exposure draft proposed that "[i]f an intermediate measure of operations is reported, revenues and expenses that are an integral part of an organization's programs or mission and supporting activities should be included in that measure. Expenses related to revenues included in an intermediate measure of operations should also be included in that measure." Some respondents commented that that guidance is more restrictive than the guidance in FASB Statement No. 117 and should be deleted because it would result in unnecessary changes in practice. The Committees agreed and therefore concluded that that guidance should be deleted.

Reporting Expenses

12. FASB Statement No. 117 requires that the statement of activities report the gross amounts of revenues and expenses. However, FASB Statement No. 117 permits an exception for investment expenses, such as custodial fees and investment advisory fees, which may be netted against investment revenues, provided that the amount of the expenses is disclosed either on the face of the statement of activities or in the notes to financial statements. In addition, FASB Statement No. 117 provides that voluntary health and welfare organizations should report expenses by their functional and natural classifications in a matrix format, because that information is meaningful to users of voluntary health and welfare organizations' financial statements. Further, FASB Statement No. 117 encourages other not-for-profit organizations to provide information about expenses by their natural classification. The Committees considered whether expenses that are netted against investment revenues should be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format if the organization presents that statement. Similarly, the Committees considered whether the natural classification of expenses that are reported by other than their natural classification, such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors, should be reported by their natural classification if information about expenses reported by their natural classification is presented. The Committees believe that permitting those expenses to be reported as other than by their natural classification defeats the purpose of reporting information about expenses by their natural classification and makes such presentations incomplete. In particular, the Committees considered circumstances in which investment expenses or cost of sales include significant payroll and payroll related expenses. The Committees believe that that information is useful to those financial statement users and that it should be required to be reported in circumstances in which the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format is presented.

Economic Interest

13. SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, provides that a not-for-profit organization should consolidate another not-for-profit organization if the reporting organization has certain kinds of control and an economic interest. The SOP provides that an economic interest is "an interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity." The SOP provides examples of economic interests. Subsequent to issuing the SOP, questions arose concerning whether a not-for-profit organization has an economic interest in another entity if the organization has a right to or a responsibility for the operating results of another entity or, upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity. The Committees believe that such circumstances result in an economic interest under the definition in the SOP. Accordingly, in applying the guidance in SOP 94-3, not-for-profit organizations should consider the example of an economic interest included in this Guide.

Noncompliance With Donor-Imposed Restrictions

14. In some circumstances, a not-for-profit organization may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). In their May 7, 1992, letter responding to a request by the FASB about the adequacy of existing accounting and auditing standards, the AICPA's Not-for-Profit Organizations Committee and Not-for-Profit Organizations Guide Task Force said:

> We believe [FASB Statement No. 5, *Accounting for Contingencies*, SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317)] require that noncompliance with donor-imposed restrictions be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue, or cause an entity not to be able to continue as a going concern. Such noncompliance could result in a material contingent liability, result in a material loss of future revenue, or cause the organization to be unable to continue as a going concern.

The Committees agree with the conclusions expressed in the May 7, 1992 letter. Accordingly, the Guide provides that noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.

Agency Transactions

15. The exposure draft, primarily chapter 5, "Contributions Received and Agency Transactions," of this Guide, included proposed guidance concerning reporting agency transactions. In addition, the letter transmitting the exposure draft specifically requested comments on issues related to variance power and donor-advised provisions. Some of the guidance included in the exposure draft, as well as tentative conclusions reached during the Committees' deliberations concerning issues related to variance power and donor-advised provisions, was more detailed than the guidance concerning agency transactions included in FASB Statement No. 116. In December 1995, the FASB released an exposure draft of a proposed Interpretation of FASB Statement No. 116, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary*. That Interpretation, which is expected to be issued close to the issuance date of this Guide, is expected to provide guidance concerning agency transactions. Accordingly, the Committees believe that sections of the Guide that provide guidance concerning agency transactions beyond the guidance included in FASB Statement No. 116 should be deleted, pending issuance of the FASB's Interpretation. The Committees expect to revise the Guide to incorporate the conclusions included in the Interpretation when it is issued.[2]

16. FASB Statement No. 116 provides that unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received. The Committees considered the application of

[2] In September 1996, the FASB issued Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (an interpretation of FASB Statement No. 116). The provisions of that Interpretation have been incorporated into this Guide.

that guidance to circumstances in which the reporting organization receives the contribution through an agent. The Committees concluded that in circumstances in which the reporting organization receives the contribution through an agent, the reporting organization has in substance received a contribution when the agent has received the contribution, including unconditional promises to give, on behalf of the reporting organization. Therefore, in order to report meaningful information about the financial position, activities, and changes in net assets of the reporting organization, the Committees concluded that if a contribution is transferred to the ultimate recipient through an agent, the ultimate recipient should recognize the contribution when sufficient verifiable evidence that the agent has received the promise to give or other assets becomes available. The Committees considered whether such guidance is operational, because the reporting organization may have no access to information about contributions that the agent has received on its behalf. The Committees believe that in most instances in which agents receive contributions on behalf of the reporting organization, the relationship of the entities will be such that the reporting organization will have access to that information.

Distinguishing Contributions From Other Kinds of Transactions

17. FASB Statement No. 116 includes guidance to help distinguish exchange transactions from contributions. However, that guidance is broad and requires judgment to implement. The exposure draft summarized the guidance in FASB Statement No. 116 concerning distinguishing exchange transactions from contributions and included indicators to help users determine whether certain transactions would be reported as contributions or exchanges. Some respondents commented that the Guide should provide more detailed guidance to help distinguish exchange transactions from contributions. In particular, some respondents noted that, due to the nature of governmental entities' missions, it may be particularly difficult to determine whether resources received from governmental entities should be reported as exchange transactions or contributions. The Committees deliberated this issue and agreed that they were unable to provide guidance beyond that provided by FASB Statement No. 116 and the exposure draft. Accordingly, the Guide includes only the indicators included in the exposure draft.

Measuring and Reporting Promises to Give

18. The exposure draft proposed that unconditional promises to give that are expected to be collected more than one year from the date of the financial statements should be reported at the gross amount of promises to give, less discounts to reflect the present value of estimated future cash flows. The exposure draft also proposed that bad debt expense be reported for the gross amount of promises to give that are expected to be uncollectible and the expense should be reflected in the net asset class in which the contribution revenue is reflected. Also, the exposure draft proposed that any subsequent differences between the estimated and actual uncollectible amounts be reported in the net asset class in which the contribution revenue was originally reflected or in the class in which the net assets are represented.

19. Some respondents commented that uncollectible promises to give should not be reported as bad debt expense because such promises are nonreciprocal transactions and the organization incurs no expense if they are not collected. They believe that contributions should be measured at the present value of the amount expected to be collected. Some believe that subsequent-year adjustments due to differences between the amount expected to be collected and the amount actually collected should be reported as adjustments to contributions in the net asset class in which the contribution was originally reported, while others believe that such adjustments should be reported as bad debt expense.

20. Others believe that uncollectible promises to give do meet the definition of expenses because such promises are assets and not collecting them is tantamount to an outflow of assets. They note that in some circumstances, management may elect to make no attempt to collect such amounts, and they believe that the effects of such decisions should be reported in the financial statements.

21. Some respondents commented that reporting bad debt expense in the net asset class in which the contribution revenue is reported conflicts with the requirement in FASB Statement No. 117 that expenses be reported as decreases in unrestricted net assets. Some respondents suggested reporting the uncollectibility of promises as a loss, rather than as an expense. Some respondents suggested reporting the uncollectibility of promises as a contrarevenue or as a reduction in contributions with financial statement disclosure of amounts netted.

22. The Committees agree that uncollectible promises to give should not be reported as expenses on the initial recognition of contributions receivable. The Committees believe such uncollectible promises are a factor to consider in determining the fair value of unconditional promises to give, and therefore are not expenses.

Split-Interest Agreements

23. Some donors enter into trust or other arrangements under which not-for-profit organizations receive benefits that are shared with other beneficiaries. Such agreements are commonly referred to as *split-interest agreements*. The guidance in the Guide concerning such agreements is based on the underlying guidance in FASB Statement No. 116, particularly the requirement that unconditional promises to give should be reported as contributions, measured at fair value. Accordingly, the Committees concluded that unconditional rights to receive assets under such agreements, such as income streams and residual interests in trusts, should be recognized as contributions measured at fair value, which is generally the present value of expected cash flows.

24. The assets related to split-interest agreements are invested and administered by either the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. In transactions not involving split-interest agreements, a trustee may hold title to assets in a trust and may have custody of them, but the assets generally are held for the benefit of the beneficiaries, not the trustee. A trustee makes decisions about investing the assets of the trust for the benefit of the holders of the beneficial interests and cannot obtain for itself the benefits represented by those assets. In split-interest agreements, however, a not-for-profit organization acting as trustee has a beneficial interest in the assets of the trust.

25. The Committees considered whether a not-for-profit organization should report assets held as trustee under such agreements, and related liabilities, in its statement of financial position. The Committees considered practice for other transactions in which entities hold assets as trustees. For example, paragraph 17.12 of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* provides that "while a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements." The Committees noted that that guidance may not be analogous to a not-for-profit organization acting as a trustee in a split-interest agreement, because such assets may be assets of the not-for-profit organization. The Committees considered whether such assets meet the definition of an asset in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. Paragraph 25 of FASB Concepts Statement No. 6 defines assets as "...probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Paragraph 26 states that—

> An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control other's access to it, and (*c*) the transaction or event giving rise to the entity's right to or control of the benefit has already occurred.

The Committees concluded that assets held by a not-for-profit organization acting as a trustee in a split-interest agreement meet the definition of an asset because (*a*) the organization has a beneficial interest in assets, (*b*) the organization can obtain the benefit and control other's access to it, and (*c*) the transaction or event giving rise to the organization's right to or control of the benefit (the split interest agreement) has already occurred. Accordingly, the Committees believe that assets held by a not-for-profit organization acting as a trustee under a split-interest agreement should be reported differently than other assets held by other entities acting as a trustee. Further, the Committees believe that reporting only the unconditional right to receive future cash flows from the trust for the organization's interest, and not the assets and liabilities related to those cash flows, would omit relevant information about the organization's performance during the period, such as the economic resources used to produce those future cash flows, and about the organization's management of those resources.

Contributed Inventory

26. The exposure draft proposed that contributions of inventory should be reported in the period received and should be measured at fair value. The exposure draft stated that the item received should not be recognized as a revenue and asset if it has no value, as might be the case for certain clothing and furniture that cannot be sold by the not-for-profit organization. Current practice under SOP 78-10 is to report contributions of inventory at fair value, provided the organization has a clearly measurable and objective basis for determining the fair value. Further, SOP 78-10 provided that, if the materials are such that values cannot be reasonably determined, such as clothing, furniture, and so forth, which vary greatly in value depending on condition and style, they should not be recorded as contributions. Most respondents that commented on this issue believe that contributed inventory should not be reported at fair value. Many respondents said that the costs of reporting that information would exceed the benefits. They believe that such information is impracticable to obtain, unreliable, and not needed by financial statement users.

27. The Committees continue to believe that information about the value of contributed inventory is meaningful and that it should be reported. However, the Committees recognize that it may be difficult to obtain. Accordingly, the Guide provides that, if methods such as the use of estimates, averages, or computational approximations can reduce the cost of measuring the fair value of contributed inventory, use of those methods is appropriate, provided the methods are applied consistently and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory.

Investments

28. FASB Statement No. 124 does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value and all investments in debt securities. Investments not covered by FASB Statement No. 124 are referred to in this Guide as *other investments*. The various AICPA Industry Audit Guides, Audit and Accounting Guides, and Statements of Position that are superseded by this Guide included guidance concerning other investments, but that guidance is inconsistent. The Committees considered whether the Guide should include measurement guidance for other investments, so that all not-for-profit organizations report other investments similarly. The Committees noted that FASB Statement Nos. 115 and 124 provide no guidance for other investments, and that practice for reporting other investments of for-profit entities is diverse. Further, the Committees noted that the Board's primary reason for excluding other investments from the scope of those projects was practical; including other investments in the scope of those projects could have raised significant issues that might not have been resolved in time to complete those projects on a timely basis. The Committees agreed that addressing issues concerning accounting for other investments could have raised significant issues that might not have been resolved in time to complete this Guide on a timely basis. Accordingly, this Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that are superseded by this Guide, until such time as the FASB or AcSEC issues more definitive guidance.

Reduction in Amounts Charged for Goods or Services

29. The exposure draft proposed that, if a not-for-profit organization regularly provides discounts to certain recipients of its goods or services, such as some types of financial aid for students, revenue should be reported net of those discounts. Though the exposure draft was silent concerning whether all financial aid provided by a college and university is a discount, the letter transmitting the exposure draft noted that the Committees believe that not all such aid is a discount and specifically asked respondents to comment on this issue. For example, benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. Most respondents that commented on this issue agreed that the Guide should provide that benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. The Committees agreed that benefits provided in exchange for goods or services provided by a not-for-profit organization are a cost of such goods or services. Accordingly, the Guide provides that reductions in amounts charged for goods or services provided by a not-for-profit organization should be reported as expenses if such reductions are given in exchange for services provided to the organization, such as part of a compensation package.

Total Fund-Raising and Program Expenses

30. FASB Statement No. 117 provides that not-for-profit organizations should report information about expenses reported by their functional classification such as major classes of program services and supporting services. Also, FASB Statement No. 117 provides that the financial statements of not-for-profit organizations should include certain minimum information. However, FASB Statement No. 117 includes no requirements concerning reporting total expenses or particular expense categories. The Committees considered whether the Guide should require not-for-profit organizations to report information other than the minimum information required by FASB Statement No. 117. In particular, the Committees considered whether information about total fund-raising and total program expenses should be reported. The Committees concluded that information about total fund-raising and program expenses is meaningful and useful to users of not-for-profit organization's financial statements. Further, the Committees agree that information about total fund-raising expenses is particularly meaningful to those financial statement users. Accordingly, the Guide provides that the financial statements should disclose total fund-raising expenses and that information about total program expenses should be provided by either disclosing total program expense or by presenting information about the components of total program expenses on the details provided on the face of the statement of activities.

Illustrative Financial Statements

31. The exposure draft did not include illustrative financial statements. FASB Statement No. 117 includes illustrative financial statements; however, those statements illustrate the application of the requirements of FASB Statement No. 117 in a broad manner, rather than illustrating the application of those requirements to specific kinds of organizations, such as colleges and universities, museums, or voluntary health and welfare organizations. The Guide includes illustrations of certain portions of financial statements, as well as certain illustrative disclosures, though it does not include illustrations of industry-specific financial statements. Some respondents commented that the Guide should include industry-specific illustrative financial statements.

32. The Committees concluded that the Guide should not be revised at this time to include illustrative financial statements that are more detailed than the illustrative financial statements included in FASB Statement No. 117. Though future editions of the Guide may include illustrative financial statements that are more detailed than the illustrative financial statements included in FASB Statement No. 117, the Committees believe that the initial version of the Guide should not include such illustrative financial statements because practice is developing in this area. The Committees believe practice should continue to develop and do not wish to inhibit that development by including illustrations that may, for practical purposes, become practice. The Committees also believe the Guide should be issued as soon as practicable and that including illustrative financial statements would likely delay its issuance. The Committees believe that illustrative financial statements will likely be included in other, nonauthoritative sources, such as continuing professional education courses and manuals issued by industry groups.

Transition

33. The transition rules in this Guide provide that if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.06 through 1.17 of this Guide, entities have the option of either applying the transition rules in the principles being adopted or reporting the cumulative effect of adopting those principles. The Committees considered requiring all changes in accounting principles that result from applying the guidance in paragraphs 1.06 through 1.17 of this Guide to be reported using the transition rules of the pronouncements being adopted. Also, the Committees considered requiring reporting the cumulative effect of all such changes, even in circumstances in which only one principle is adopted. The Committees permitted reporting the cumulative effect in circumstances in which there is more than one change in accounting principle because applying the transition rules in each principle adopted may result in confusing information, the benefits of which would not exceed its costs. However, the Committees concluded that in circumstances in which there is only one change in accounting principle, it would be inconsistent with the principle being adopted to conclude that the cost of applying the transition rules of the principle being adopted exceeds the benefits of applying those transition rules.

Appendix B

Statement of Position 92-9

Audits of Not-for-Profit Organizations Receiving Federal Awards

With Conforming Changes as of December 18, 1995, Resulting From the Issuance of *Government Auditing Standards: 1994 Revision* and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*

Prepared by the Not-for-Profit Organizations Committee

American Institute of Certified Public Accountants

[Superseded by the issuance of SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards.* See appendix D of this Guide.]

Appendix C

Statement of Position 98-2

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

March 11, 1998

Amendment to
AICPA Audit and Accounting Guides
Health Care Organizations,
Not-for-Profit Organizations, **and**
Audits of State and Local Governmental Units

Issued by the Accounting
Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.*

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

* This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object.

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

Introduction

1. Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,[1] such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities.**[2] These **activities** include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities.**[3] Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

2. External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

3. In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.*[4] SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those

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[1] This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

[2] Terms that appear in the Glossary are set in **boldface type** the first time they appear.

[3] The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D-5 of this SOP, those entities are required to report fund raising as part of the "institutional support" function.)

[4] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations.* The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* because the provisions of SOP 87-2 are incorporated into paragraphs 13.31 to 13.40 of *Not-for-Profit Organizations. Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.31 to 13.40 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.*

materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

4. The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B, "Background," discusses this further.)

5. This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F provides explanations and illustrations of some acceptable allocation methods.

Scope

6. This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

7. If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

8. The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs 9 and 10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph 9 provides guidance pertaining to program functions only. Paragraph 10 provides guidance pertaining to both program and management and general functions.)

9. *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph 10 should also be considered in determining whether the purpose criterion is met.

10. *Program and management and general functions.* The following factors should be considered, in the order in which they are listed,[5] to determine whether the purpose criterion is met:

a. *Whether* ***compensation or fees*** *for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of any com-

[5] In considering the guidance in paragraph 10, the factor in paragraph 10*a* (the compensation or fees test) is the preeminent guidance. If the factor in paragraph 10*a* is not determinative, the factor in paragraph 10*b* (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph 10*b* is not determinative, the factor in paragraph 10*c* (other evidence) should be considered.

ponent of the discrete joint activity varies based on contributions raised for that discrete joint activity.[6, 7]

b. *Whether a similar program or management and general activity is conducted separately and on the same scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

— The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and

— A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.[8]

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

If the purpose criterion is met based on the factor in paragraph 10*b*, the factor in paragraph 10*c* should not be considered.

c. *Other evidence.* If the factors in paragraph 10*a* or 10*b* do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

11. The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).

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[6] Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is $10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

[7] The *compensation or fees test* is a negative test in that it either (*a*) results in failing the purpose criterion or (*b*) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph 10*b* should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph 10*b* should be considered.

[8] Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

- *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.

b. Evidence that the purpose criterion may not be met includes—

- *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (*a*) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (*b*) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.

c. Evidence that the purpose criterion may be either met or not met includes—

- *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
- *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.
  - If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
  - If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (*a*) employees who are not members of the fund-raising department and (*b*) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.

- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
  - — The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
  - — Minutes of board of directors', committees', or other meetings.
  - — Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
  - — Long-range plans or operating policies.
  - — Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
  - — Internal management memoranda.

Audience

12. A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph 13*a*, 13*b*, or 13*c*. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph 13*a*, 13*b*, or 13*c*. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

13. In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity

b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity

c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

14. The content criterion is met if the joint activity supports program or management and general functions, as follows:

a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.[9]

15. Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

16. The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

17. Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [*address*]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [*a particular cause*]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

18. Entities that allocate joint costs should disclose the following in the notes to their financial statements:

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[9] Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

a. The types of activities for which joint costs have been incurred

b. A statement that such costs have been allocated

c. The total amount allocated during the period and the portion allocated to each functional expense category

19. This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

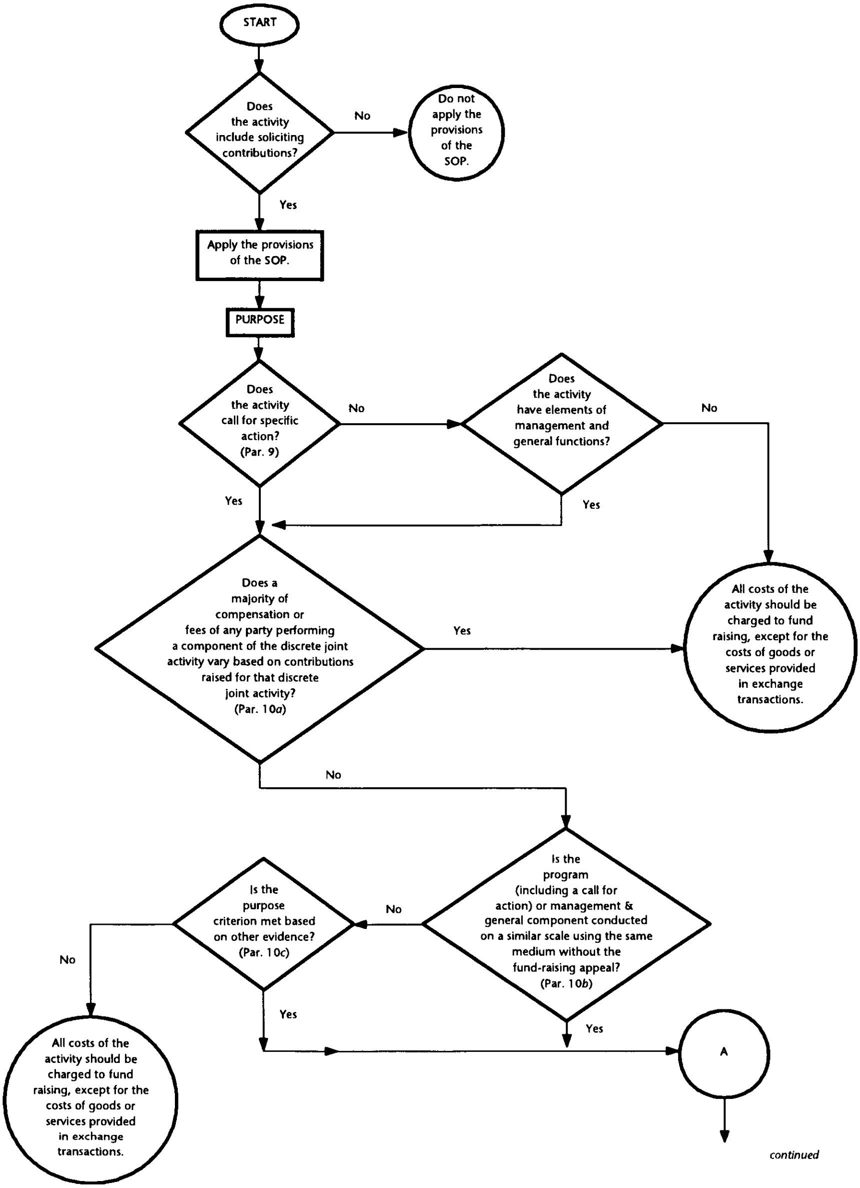
Effective Date

20. This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

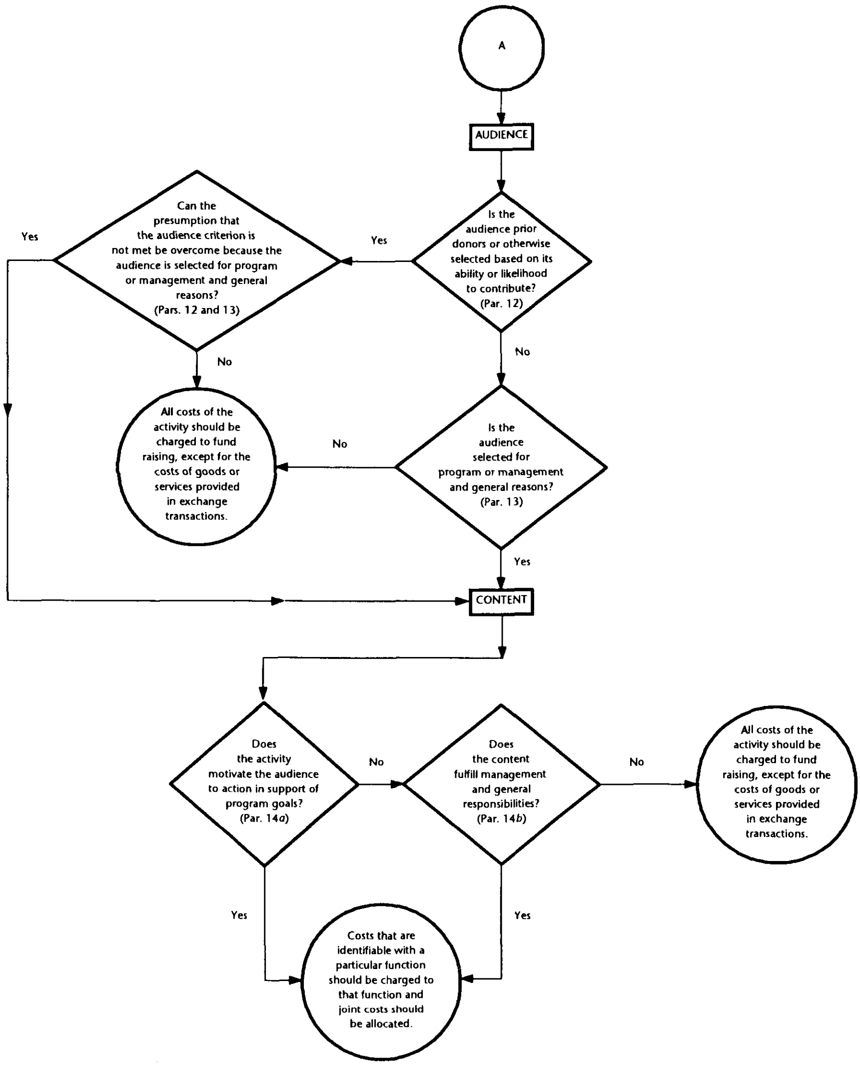
The provisions of this Statement of Position need not be applied to immaterial items.

APPENDIX A

Accounting for Joint Activities[10]



[10] *Note:* This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.


A
AUDIENCE
Is the audience prior donors or otherwise selected based on its ability or likelihood to contribute? (Par. 12)
Yes
Can the presumption that the audience criterion is not met be overcome because the audience is selected for program or management and general reasons? (Pars. 12 and 13)
Yes
No
All costs of the activity should be charged to fund raising, except for the costs of goods or services provided in exchange transactions.
No
Is the audience selected for program or management and general reasons? (Par. 13)
No
Yes
CONTENT
Does the activity motivate the audience to action in support of program goals? (Par. 14a)
No
Does the content fulfill management and general responsibilities? (Par. 14b)
No
All costs of the activity should be charged to fund raising, except for the costs of goods or services provided in exchange transactions.
Yes
Yes
Costs that are identifiable with a particular function should be charged to that function and joint costs should be allocated.

APPENDIX B

Background

B.1. As stated in paragraph 4, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that "some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services." It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

APPENDIX C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (*a*) the purpose of the activity include educating the public about causes, (*b*) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (*c*) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph 9, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (*a*) substantially all compensation or fees for performing the activity are based on amounts raised or (*b*) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of "based on contributions raised" included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph 10*a* is not biased against entities that hire professional fund raisers, because it applies to the entity's employees as well as professional fund raisers. For example, if a majority of an employee's compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph 11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph 13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph 13*c* provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph 14*b* provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph 14*b* provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (*a*) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (*b*) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (*a*) requirements that must be met as a result of receiving contributions and (*b*) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that "the term *accounting principle* includes 'not only accounting principles and practices but also the methods of applying them.'" APB Opinion 20 also states in paragraphs 15 and 16 that

> . . . In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type . . . . The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph 16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph 19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

APPENDIX D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations,* specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.30 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses.

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities,* provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made,* and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models,* requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities,* as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities,* and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

D.6. As discussed in footnote 3 to paragraph 1 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

Assigning Costs of Joint Activities

D.7. Paragraph 7 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . ." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph 9 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph 12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph 13. Further, paragraph 12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost $500 to attend a dinner with a fair value of $50. In that case, the audience is required to make a $450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph 13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph 13*c* provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary, the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

a. Actions that benefit the recipient:
- *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
- *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.

b. Actions that benefit society:
- *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.

- *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
- *Boycott.* The particular product or company to be boycotted should be specified.

D.15. Paragraph 14*b* provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph 14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph 16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

APPENDIX E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph 10*b*.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.[11] All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than

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[11] Paragraph 7 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (*b*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (*c*) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) performing such programs helps accomplish Entity D's mission, and (*b*) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (*b*) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (*b*) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid $25,000 for this activity, with a $5,000 bonus if the activity raises over $1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph 10*a* were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid $5,000 if the activity raises over $1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because $5,000 would not be a majority of the executive producer's total compensation of $30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph 11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (*b*) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of $75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (*a*) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (*b*) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (*b*) it otherwise conducts the program activity without a request for contributions, and (*c*) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14

Facts

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[12])

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[12] Paragraphs 13.17 to 13.22 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at $250, which is above the $50 fair value of the lecture and, therefore, $200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the $250 admission price includes a $200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[13])

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[13] Paragraphs 13.17 to 13.22 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (*b*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (*c*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (*d*) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

APPENDIX F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total $20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total $80,000. Joint costs associated with the direct mail campaign total $40,000 and would be allocated as follows under the relative direct cost method:

Program	$20,000/$100,000 × $40,000 = $8,000
Fund raising	$80,000/$100,000 × $40,000 = $32,000

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of $100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been $90,000 for the program component and $70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the $100,000 in joint costs would be allocated as follows: $90,000/$160,000 × $100,000 = $56,250 to program services and $70,000/$160,000 × $100,000 = $43,750 to fund raising.

APPENDIX G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs 18 and 19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of $310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [***Note to reader:*** *The following sentence is encouraged but not required.*] Joint costs for each kind of activity were $50,000, $150,000, and $110,000 respectively. These joint costs were allocated as follows:

Fund raising	$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	$310,000

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of $310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	Direct Mail	*Special Events*	*Telethon*	*Total*
Fund raising	$40,000	$50,000	$90,000	$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	$50,000	$150,000	$110,000	$310,000

[***Note to reader:*** *Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity ($50,000, $150,000, and $110,000) is encouraged but not required.*]

APPENDIX H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2[14]

This SOP	*SOP 87-2*
Applies to all entities that solicit contributions, including state and local governments.	Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.*)
Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)	Covers only joint costs of joint activities.
Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.	Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

[14] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* because the guidance in SOP 87-2 is incorporated into paragraphs 13.31 to 13.40 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.31 to 13.40 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

This SOP	*SOP 87-2*
Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.	Neither prescribes nor prohibits any allocation methods. No illustrations are provided.
Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.	Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

APPENDIX I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.31 to 13.40 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations.*

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.17, 13.19, and 13.20 of *Not-for-Profit Organizations* are amended as follows:

> **13.17** Some organizations conduct joint activities* that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.
>
> ---
>
> * See the sections of this Guide that provide guidance concerning accounting for the costs of joint activities.
>
> **13.19** For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of $100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (*a*) $5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (*b*) fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.
>
> **13.20** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		$200
Special event revenue	100	
Less: Costs of direct benefits to donors	(25)	
Net revenues from special events		75
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		35
Total other expenses		115
Increase in unrestricted net assets		$160

Illustration 2

Changes in unrestricted net assets:	
Revenues:	
Contributions	$200
Special event revenue	100
Total revenues	300
Expenses:	
Program	60
Costs of direct benefits to donors	25
Management and general	20
Fund raising	35
Total expenses	140
Increase in unrestricted net assets	$160

Illustration 3

Changes in unrestricted net asset:	
Contributions	$270
Dinner sales	30
Less: Costs of direct benefits to donors	(25)
Gross profit on special events	5
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund raising	35
Total other expenses	115
Increase in unrestricted net assets	$160

I.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB

Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.

Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

Appendix D

Statement of Position 98-3

Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards

March 17, 1998

Includes Guidance on the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 Revision)

Supersedes AICPA Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards,* and Part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*

Issued Under the Authority of the Auditing Standards Board

American Institute of Certified Public Accountants

NOTE

This Statement of Position presents the recommendations of the AICPA Single Audit Working Group regarding the performance of audits in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This edition incorporates guidance contained in *Government Auditing Standards* (1994 revision) and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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Appendix B—OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

Appendix C—Illustrative Schedules of Expenditures of Federal Awards

Appendix D—Illustrative Auditor's Reports

Appendix E—Illustrative Schedule of Findings and Questioned Costs

SUMMARY

This Statement of Position (SOP) provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This SOP supersedes SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units.*

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of the Single Audit Act Amendments of 1996 and Circular A-133.
- Describes the auditor's responsibility for testing and reporting on the schedule of expenditures of federal awards.
- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under generally accepted auditing standards, *Government Auditing Standards*, and Circular A-133.
- Describes the auditor's responsibility for reporting and provides examples of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit.

Further, this SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133
- AICPA Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- *Government Auditing Standards* (1994 revision)
- The OMB Circular A-133 *Compliance Supplement* (June 1997 revision)

Chapter 1

INTRODUCTION AND OVERVIEW

Introduction

Purpose and Applicability

1.1 The purpose of this Statement of Position (SOP) is to provide auditors of states, local governments, and not-for-profit organizations (NPOs) that receive federal awards with a basic understanding of the procedures they should perform and of the reports they should issue for single audits and program-specific audits under—

a. The Single Audit Act Amendments of 1996 (hereinafter referred to as the Single Audit Act or the Act).[1]

b. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*,[2] and the related *OMB Circular A-133 Compliance Supplement*.

c. The standards applicable to financial audits contained in the 1994 revision of *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. General Accounting Office (GAO).[3] These standards incorporate the fieldwork and reporting standards of generally accepted auditing standards (GAAS)[4] issued by the American Institute of Certified Public Accountants (AICPA).

1.2 This SOP provides guidance about financial and compliance auditing standards and requirements related to single audits (chapters 1 through 10) and program-specific audits (chapter 11) for entities (also referred to as auditees) subject to the Single Audit Act and Circular A-133. Applicable standards and requirements are promulgated by the OMB, GAO, and AICPA. This SOP also provides guidance on applicable auditing standards and requirements established by those organizations to assist auditors in planning, performing, and reporting on single audits and program-specific audits in ac-

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[1] The Single Audit Act Amendments of 1996 (Public Law 104-156) was enacted into law in July 1996 and replaced the Single Audit Act of 1984. A reprint of the Single Audit Act Amendments of 1996 is included in appendix A of this SOP.

[2] Circular A-133 (as revised on June 30, 1997), is reprinted in appendix B of this SOP.

[3] The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

[4] GAAS requirements are discussed in this SOP to the extent necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant AICPA Statements on Auditing Standards and also related Audit and Accounting Guides such as *Not-for-Profit Organizations, Health Care Organizations,* and *Audits of State and Local Governmental Units* for additional information on GAAS requirements.

cordance with those standards and requirements, and includes illustrative audit reports. Since Circular A-133 is the federal policy guidance to which auditors are held in performing single audits, this SOP will primarily focus on its requirements.

1.3 This SOP is organized by chapters in which the important considerations in performing single audits and program-specific audits are discussed (see table of contents).

1.4 This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in the audits of every entity. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement, so that the audit objectives may be achieved.

1.5 Auditors should be aware that certain states have imposed additional audit requirements related to state or local financial assistance. The guidance in this SOP does not extend to individual state requirements (except for the guidance in paragraphs 3.47, 3.48, and 6.71). Furthermore, pass-through entities may impose additional audit requirements on their subrecipients related to the financial assistance passed through. The guidance in this SOP also does not extend to those requirements.

Definitions

1.6 The terms used in this SOP are intended to be consistent with the definitions in the Single Audit Act and Circular A-133. Similarly, the term *not-for-profit organization* as used in this SOP is consistent with the definition of the term *non-profit organization* in Circular A-133 (see appendix B) and includes not-for-profit institutions of higher education, hospitals, and other health care providers.

Effective Dates

1.7 The requirements of the Single Audit Act and Circular A-133 are effective for audits of fiscal years beginning after June 30, 1996. This SOP also includes auditing guidance through AICPA Statement on Auditing Standards (SAS) No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). The effective dates of this auditing guidance should be applied as provided for in the related literature. This SOP does not change the effective dates of the auditing standards, the act, and Circular A-133. The remaining provisions of this SOP are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. Earlier application is encouraged.

Objectives of a Single Audit

1.8 A single audit has two main objectives: (*a*) an audit of the entity's financial statements and the reporting on the schedule of expenditures of federal awards in relation to those financial statements and (*b*) a compliance audit of federal awards expended during the fiscal year. Each of these results in the preparation and issuance of certain audit reports (see paragraph 2.7 for a more detailed description of the audit objectives).

Audit of Entity's Financial Statements and Reporting on the Schedule of Expenditures of Federal Awards

1.9 The financial statement audit required by Circular A-133 is performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* and GAAS, and it results in the auditor reporting on the entity's financial statements and on the scope of the auditor's testing of compliance and internal control over financial reporting and presents the results of those tests. The primary sources of guidance and standards regarding financial statement audits are the AICPA Statements on Auditing Standards (SASs), particularly SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801); *Government Auditing Standards*; and the following AICPA Audit and Accounting Guides, as applicable: *Not-for-Profit Organizations, Audits of State and Local Governmental Units, Health Care Organizations,* and *Audits of Colleges and Universities.*[5] Refer to chapter 4 for a more detailed discussion of financial statement audit considerations under Circular A-133. Guidance on reporting on the schedule of expenditures of federal awards is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Refer to chapter 5 for a more detailed discussion of the schedule of expenditures of federal awards.

Compliance Audit of Federal Awards

1.10 Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with *Government Auditing Standards* and GAAS. The compliance audit of federal awards expended during the fiscal year provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance.[6] The various types of federal awards and payment methods are described in paragraphs 1.17 through 1.23. Compliance auditing considerations applicable to major programs and internal control over compliance are discussed in chapters 6 and 8. Reporting is discussed in chapter 10.

Adherence to Professional Standards and Requirements

1.11 The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*, states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons for doing so are given.

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[5] Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

[6] A major program is defined in Circular A-133. See the discussion of the determination of major programs in chapter 7.

Relationship of the Single Audit Act, Circular A-133, Government Auditing Standards, and GAAS

1.12 The Single Audit Act Amendments of 1996 were enacted to streamline and improve the effectiveness of audits of federal awards and to reduce the audit burden on states, local governments, and NPOs. Those goals were achieved, in part, by increasing the dollar threshold for requiring a single audit to $300,000 in federal awards expended from $25,000 in federal awards received and introducing a risk-based approach for determining which federal programs are to be considered major programs (see paragraph 2.2 for a further discussion of the audit threshold). The Single Audit Act requires single audits and program-specific audits of federal awards to be performed in accordance with *Government Auditing Standards,*[7] and gives the Director of OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the Act. The OMB established audit guidelines and policy in Circular A-133, which was revised and issued June 30, 1997,[8] and establishes a uniform system of auditing states, local governments, and NPOs that expend federal awards. (Chapter 2 provides an overview of Single Audit Act and Circular A-133 requirements.) Circular A-133 has been adopted in regulation by individual federal departments and agencies.

1.13 In performing audits in accordance with the standards applicable to financial audits contained in *Government Auditing Standards,* the auditor assumes certain responsibilities beyond those of audits performed in accordance with GAAS.[9] *Government Auditing Standards* includes general standards, incorporates the fieldwork and reporting standards under GAAS, and includes additional fieldwork and reporting standards. *Government Auditing Standards* includes additional standards in such areas as quality control reviews, continuing professional education, working papers, and audit follow-up (see paragraphs 3.8 through 3.21 for a detailed discussion of the additional standards). The reporting responsibilities in *Government Auditing Standards* require additional reporting on compliance and on internal control over financial reporting (see paragraphs 3.19 through 3.21, 10.15, and 10.16 for a detailed discussion of the reporting requirements).

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[7] *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards applicable to financial audits and not the performance audit standards (see footnote 3). However, *Government Auditing Standards* states that auditors should follow, as appropriate, the report contents standards for objectives, scope, and methodology; audit results; the view of responsible officials; and its report presentation standards. A discussion of these standards is contained in the performance auditing standards in chapter 7 of *Government Auditing Standards* (see paragraph 10.21).

[8] The June 30, 1997, revision to Circular A-133 superseded OMB Circular A-128, *Audits of State and Local Governments,* and all previous versions of Circular A-133.

[9] Paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions in relation to the guidance in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316).

Compliance Testing

1.14 Table 1.1 presents the relationship among the compliance testing requirements of GAAS, Government Auditing Standards, the Single Audit Act, and Circular A-133. Compliance testing requirements are discussed in detail in chapter 6. SAS No. 74 provides general guidance on the auditor's responsibility for compliance auditing under GAAS, *Government Auditing Standards*, and federal audit requirements. In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit is described. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors.

Internal Control Consideration

1.15 Table 1.2 presents the relationship among the requirements to consider internal control under GAAS, *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Internal control requirements are discussed in detail in chapters 4 and 8.

Table 1.1

Compliance Testing

	Fieldwork Responsibilities	*Reporting Responsibilities*
Generally accepted auditing standards	Design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 54, *Illegal Acts by Clients*, as described in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and to provide reasonable assurance about whether the financial statements are free of material misstatements (whether caused by error or fraud), as described in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit,* and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit.*	Requires the auditor to adequately inform the audit committee or others with equivalent authority and responsibility about any illegal acts that the auditor becomes aware of during the audit unless they are clearly inconsequential. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. When the auditor identifies fraud risk factors that have continuing control implications, the auditor should communicate those factors that are considered reportable conditions to senior management and the audit committee. See SAS No. 82, paragraphs 38 through 40, for an additional discussion of the reporting requirements of SAS No. 82.
Government Auditing Standards	Same responsibilities as required by GAAS, but *Government Auditing Standards* specifically states that auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts.	Requires a written report describing the scope of the auditor's testing of compliance with laws and regulations and presenting the results of those tests (additional details on the reporting responsibilities are included in paragraphs 10.15, 10.16, and 10.21 through 10.25).
Single Audit Act and Circular A-133	Determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program.	Requires the auditor to express an opinion on whether the entity complied with laws, regulations, and with the provisions of contracts or grant agreements which could have a direct and material effect on each major program and, where applicable, refer to a separate schedule of findings and questioned costs.

Table 1.2

Internal Control Responsibilities

	Fieldwork Responsibilities	*Reporting Responsibilities*
Generally accepted auditing standards	Obtain an understanding of internal control over financial reporting sufficient to plan the audit by performing procedures to understand both the design of controls relevant to an audit of financial statements and whether they have been placed in operation, and assess control risk, in accordance with SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit,* as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55.*	Requires the auditor to communicate, either orally or in writing, any reportable conditions as described in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit.*
Government Auditing Standards	Same responsibilities as GAAS. *Government Auditing Standards* provides additional guidance on the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments.	Requires a written report describing the scope of the auditor's testing of internal control and presenting the results of those tests. Also requires separate identification and written communication of all reportable conditions, including those reportable conditions that are individually or cumulatively material weaknesses.
Single Audit Act and Circular A-133	With regard to internal control over compliance, the auditor is required to do the following (in addition to the requirements of *Government Auditing Standards*): (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, (2) plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program,* and (3) perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance).	Requires a written report on internal control over major programs describing the scope of testing internal control and the results of the tests, and, where applicable, referring to a separate schedule of findings and questioned costs.

* Circular A-133 requires the auditor to plan the audit to support a low assessed level of control risk for major programs; however, it does not actually require the achievement of a low assessed level of control risk. See paragraphs 8.16 through 8.22.

Reporting

1.16 A matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133 appears in table 1.3. Reporting is discussed in detail in chapter 10.

Table 1.3

Recommended Reporting in Single Audits

	Required by—		
Report	*GAAS*	Government Auditing Standards	*Circular A-133*
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Types of Federal Awards and Payment Methods

Definition of Federal Awards

1.17 Circular A-133 defines federal awards as *federal financial assistance* and *federal cost-reimbursement contracts* that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts (under grants or contracts) used to buy goods or services from vendors. See paragraph 2.15 for a discussion of subrecipient and vendor determinations.

Federal Financial Assistance—Classification and Types

1.18 Federal sponsors have classified federal financial assistance into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. Circular A-133 defines federal programs as all federal awards under the same CFDA number. Certain clusters of federal programs should be treated as one program for determining major programs. Research and development, student financial aid, and certain other programs are defined as a cluster in the *OMB Circular A-133 Compliance Supplement* because they are closely related and share common compliance requirements (see paragraphs 1.26 through 1.28 and chapters 2 and 6 for additional discussion of the *Compliance Supplement*).

1.19 Sometimes state governments combine funding from different federal awards in providing assistance to their subrecipients when the awards are closely related programs and share common compliance requirements. In this case, Circular A-133 states that the state may require the subrecipient to treat the combined federal awards as a cluster of programs. See paragraph 2.18 for further information.

1.20 There are over 1,000 individual grant programs and several distinct types of federal award payment methods. Many of these programs are described in the CFDA; however, certain programs may not be included. For example, contracts may not be listed in the CFDA. Circular A-133 states that when a CFDA number is not assigned, all federal awards from the same agency that are made for the same purpose should be combined and considered one program.

1.21 Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* For activities of a continuing nature not confined to a specific project, allocations of money to nonfederal entities are made in accordance with a distribution formula prescribed by law or administrative regulation. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services. Another example is the Department of Justice's award to state and local governments for drug control and systems improvement.
- *Project grants.* These involve the funding (for fixed or known periods) of specific projects, or the delivery of specific services or products, without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance is provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance is provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance is provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* For these programs, the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for the repayment of loans.
- *Insurance.* Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.
- *Sale, exchange, or donation of property and goods.* These programs provide for the sale, exchange, or donation of federal real property, per-

sonal property, commodities, and other goods, including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

Federal Cost-Reimbursement Contracts

1.22 The definition of federal awards also includes federal cost-reimbursement contracts. These are contracts with nonfederal entities to provide goods or services to the federal government. These contracts are generally governed by the Federal Acquisition Regulations (found in part 41 of the *Code of Federal Regulations*) and the terms of the contracts.

1.23 Awards may be provided to entities through reimbursement arrangements in which recipients bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit entities to draw cash as grant expenditures are incurred.

Determining the Scope of a Single Audit

1.24 The scope of the auditor's work in an audit in accordance with Circular A-133 is determined by (*a*) the level of assessed risk associated with the federal programs and whether they are identified as a major program and (*b*) the compliance requirements applicable to those programs.

Risk-Based Approach

1.25 The audit scope depends on whether the federal awards expended are identified as relating to major programs. Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides criteria for the auditor to use in applying a risk-based approach. The auditor's determination of the programs to be audited is based on an overall evaluation of the risk of noncompliance occurring which could be material to the individual federal programs. In evaluating risk, the auditor considers, among other things, the current and prior audit experience with the auditee, oversight by the federal agencies and pass-through entities, and the inherent risk of the federal programs. Chapter 7 includes a detailed discussion of applying the risk-based approach to determining major programs.

Compliance Requirements

1.26 Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The term *compliance requirements* refers to the laws, regulations, and provisions of contracts and grant agreements that an auditor should consider in making this determination (see chapter 6 for a more detailed discussion).

1.27 The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement*.[10]

1.28 With regard to federal programs included in the *Compliance Supplement*, the auditor should follow the guidance contained in the *Compliance Supplement* for testing compliance requirements. The auditor should be aware

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[10] A copy of the *Compliance Supplement* may be obtained from EOP Publications, Office of Administration, 2200 NEOB, Washington, D.C. 20503; (202) 395-7332. It is also available from the OMB's home page at http://www.whitehouse.gov/WH/EOP/omb, under the captions "OMB Documents," and then "Grants Management," and the Office of Inspector General home page at http://www.ignet.gov.

that compliance requirements may change over time. Thus, the auditor should also inquire of the auditee and review the provisions of grant agreements to determine whether compliance requirements reflected in the *Compliance Supplement* have changed. If there have been changes, the auditor should follow the provisions of the *Compliance Supplement* as modified by the changes (see chapters 2 and 6 for a more detailed discussion of the *Compliance Supplement*). For programs not listed in the *Compliance Supplement*, the auditor should follow *Compliance Supplement* part 7 "Guidance for Auditing Programs Not Included in This Compliance Supplement," which instructs the auditor to use the types of compliance requirements (for example, cash management, reporting, allowable costs/cost principles, activities allowed or unallowed, eligibility, and matching, level of effort, and earmarking) contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

1.29 In addition, some agencies have developed audit guides or supplements related to their programs. Auditors should consult with the applicable federal agency to determine the availability of agency-prepared supplements or audit guides. This guidance, where applicable, may be obtained from the Office of Inspector General of the appropriate federal agency.

The Auditor's Responsibilities in Single Audits—An Overview

Compliance With Laws and Regulations

1.30 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to provide an opinion on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The auditor's responsibility for compliance auditing is discussed further in chapter 6. The required reporting and the schedule of findings and questioned costs are discussed in chapter 10.

Internal Control Over Compliance

Planning

1.31 In a single audit, the auditor must obtain an understanding of the design and operation of internal control over compliance with requirements that could have a direct and material effect on a major program. The auditor's work in this area is in addition to the consideration of internal control over financial reporting that is part of a financial statement audit. Specifically, the auditor must obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs.

Testing

1.32 Circular A-133 also requires auditors to test internal control over compliance by implementing the planned tests. Evidence gained from the tests of controls relevant to compliance requirements may be used by the auditor to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements applicable to major programs. The requirements and auditor responsibilities associated with internal control over compliance in a single audit are discussed in chapter 8.

Chapter 2

OVERVIEW OF THE SINGLE AUDIT ACT, CIRCULAR A-133, AND THE *OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT*

2.1 This chapter provides an overview of the significant requirements and guidance in the Single Audit Act, Circular A-133, and the *OMB Circular A-133 Compliance Supplement*. Because Circular A-133 incorporates the requirements of the Single Audit Act and provides additional guidance, the requirements of the Act and Circular A-133 are discussed together as one in this SOP. Accordingly, references to Circular A-133 also include the requirements of the Single Audit Act. Auditors should refer to the Single Audit Act, Circular A-133, and the *Compliance Supplement* for a complete understanding of the requirements. The Single Audit Act and Circular A-133 are reprinted in appendixes A and B, respectively. See footnote 10 of chapter 1 for instructions on how to obtain a copy of the *Compliance Supplement*.

Single Audit Act and Circular A-133 Requirements

General Audit Requirements

Audit Threshold

2.2 Entities that expend $300,000 or more in a fiscal year in federal awards are subject to the Single Audit Act and Circular A-133 and, therefore, must have a single or program-specific audit. Entities expending awards under only one program (excluding research and development [R&D]) may elect to have a program-specific audit if the program's laws, regulations, or grant agreements do not require a financial statement audit. A program-specific audit may not be elected for R&D unless (*a*) all expenditures are for awards received from the same federal agency or from the same federal agency and the same pass-through entity and (*b*) advance approval is obtained (see chapter 11 for additional guidance on program-specific audits). Entities that expend less than $300,000 in a fiscal year in federal awards are exempt from audit requirements in the Single Audit Act and Circular A-133. However, those entities are not exempt from other federal requirements (including those to maintain records) concerning federal awards provided to the entity. Such records must be available for review or audit by appropriate officials of a federal agency, pass-through entity, and the GAO. The Single Audit Act provides that, every two years, the OMB may review the amount for requiring audits and may raise the dollar threshold amount above $300,000.

Applicable Standards and Covered Entity

2.3 Circular A-133 audits must be conducted by an independent auditor[1] in accordance with *Government Auditing Standards*, and they must cover the entire operations of the auditee or, at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other or-

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[1] The Single Audit Act defines "independent auditor" as (*a*) an external state or local government auditor who meets the independence standards included in *Government Auditing Standards* or (*b*) a public accountant who meets such independence standards.

ganizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and the schedule of expenditures of federal awards for each such department, agency, and organizational unit (see paragraph 3.25 for a more detailed discussion of this requirement).

Relation to Other Audit Requirements

2.4 A Circular A-133 audit is deemed to be in lieu of any financial audit of federal awards that an entity is required to undergo under any other federal law or regulation. However, notwithstanding a Circular A-133 audit, a federal agency (including its Inspectors General or GAO) may conduct or arrange for additional audits (for example, financial audits, performance audits, evaluations, inspections, or reviews) that are necessary to carry out their responsibilities under federal law or regulation. Any additional audits should be planned and performed in such a way as to build upon work performed by auditors. A federal agency that conducts or contracts for additional audits must arrange for funding the full cost of such additional audits. See paragraph 2.19 for a discussion of the federal agency option to request certain programs to be audited as major programs.

Frequency of Audits

2.5 Circular A-133 audits must be performed annually unless an auditee meets one of the following criteria that would allow it to have biennial audits (biennial audits should cover both years within the biennial period):

- State or local governments that are required by constitution or statute (in effect on January 1, 1987) to undergo audits less frequently than annually are permitted to have Circular A-133 audits performed biennially. This requirement must still be in effect for the biennial period under audit.
- NPOs that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, are permitted to have Circular A-133 audits performed biennially.

Non-U.S.-Based Entities

2.6 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. For example, if a federal agency provides financial assistance to an orphanage operated by a foreign government, Circular A-133 would not apply. However, the circular does apply to expenditures made by U.S.-based entities outside of the United States and by foreign branches of U.S.-based entities. For example, if a university based in the United States receives a federal award for travel and a three-month residence in a foreign country to conduct research, Circular A-133 would apply to the travel and the related research costs incurred in the foreign country. Another example would be a hospital that receives a federal award to perform medical research in a foreign country. If the research is conducted in the hospital's research laboratory based in the foreign country, the federal award would be subject to an audit under Circular A-133.

Audit Objectives and Reporting Matters

Audit Objectives

2.7 In a single audit, the auditor's objectives are to—

- Determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. (Note that Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. See paragraphs 4.2 and 4.3 for a further discussion.)

- Determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.
- Obtain an understanding of the internal control over compliance for each major program, assess the control risk, and perform tests of those controls unless the controls are deemed to be ineffective (the auditor must perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for each major program).
- Determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each of its major programs.

Audit Reports

2.8 Section 505 of Circular A-133 includes specific auditor reporting requirements. Those requirements are summarized in paragraph 10.3. See paragraphs 10.8 through 10.10 for a description of the reports illustrated in this SOP to meet the reporting requirements of Circular A-133.

Timing of the Submission of the Report

2.9 The audit should be completed and the data collection form and the reporting package (described in paragraphs 2.24, 2.25, 10.6, and 10.7), including the auditor's reports, should be submitted by the auditee (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit (see paragraphs 10.74 through 10.79 for a further discussion).[2]

Audit Follow-Up

2.10 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 3.24 and 6.61 through 6.67 for a further discussion of the auditor's responsibility for audit follow-up.)

Auditor Selection and Audit Costs

Procurement of Audit Services and Restriction on Auditors Who Prepare Indirect Cost Proposals

2.11 Circular A-133 also establishes guidance on the procurement of audit services, as well as guidance on the restrictions on the selection of audi-

[2] Auditors should note that there is a delayed implementation for this requirement. Therefore, for fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and the reporting package should be submitted (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's report or thirteen months after the end of the audit period.

tors who also prepare the indirect cost proposal or cost allocation plan. Auditors who prepare the indirect cost proposal or cost allocation plan may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee during the prior year exceeded $1 million.[3] See paragraph 3.52 for additional information on this restriction.

Audit Costs

2.12 Circular A-133 provides guidance on whether the charging of audit costs to federal awards may be allowed. Unless prohibited by law, the costs of Circular A-133 audits are allowable charges to federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB Cost Principles Circulars, the Federal Acquisition Regulation, or other applicable cost principles or regulations. The costs of single audits that are not conducted in accordance with Circular A-133 are unallowable. Furthermore, audit costs associated with Circular A-133 audits of entities that expend less than $300,000 per year in federal awards are unallowable. However, this provision does not prohibit pass-through entities from charging federal awards for the costs of limited-scope audits to monitor its subrecipients. See paragraph 9.32 for further information on the allowability of audit costs associated with limited-scope audits. With regard to the amount of audit cost that can be charged to a federal award, the Single Audit Act states that in the absence of documentation demonstrating a higher actual cost, the percentage of the cost of single audits charged to federal awards by an entity may not exceed the ratio of total federal awards expended to the entity's total expenditures for the fiscal year.

Basis for Determining When Federal Awards Are Expended

2.13 The determination of when an award is expended is based on when the activity related to the award occurs. In general, the activity pertains to events that require the auditee to comply with laws, regulations, and the provisions of contracts or grant agreements. Such events include the following:

- Expenditure/expense transactions associated with grants, cost reimbursement contracts, cooperative agreements, and direct appropriations
- The disbursement of funds passed through to subrecipients
- The use of loan proceeds under loan and loan-guarantee programs
- The receipt of property
- The receipt of surplus property
- The receipt or use of program income
- The distribution or consumption of food commodities
- The disbursement of amounts entitling the auditee to an interest subsidy
- The period when insurance is in force

2.14 Circular A-133 provides specific guidance on the basis of determining federal awards expended for the following noncash items (see paragraphs 5.13 through 5.15 for additional discussion):

- Loans and loan guarantees, including those at institutions of higher education

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[3] The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998.

- Prior loans and loan guarantees
- Endowment funds
- Free rent
- Noncash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property
- Medicare payments to a nonfederal entity for providing patient care services
- Medicaid payments to a subrecipient for providing patient care services

Subrecipient and Vendor Determinations

2.15 An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient are subject to audit under Circular A-133. The payments received for goods or services provided as a vendor would not be considered federal awards. Circular A-133 provides specific guidance on determining whether payments constitute a federal award or a payment for goods and services. This guidance is discussed further in chapter 9.

Major Program Determination

Risk-Based Approach

2.16 Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. The risk-based approach includes consideration of current and prior audit experience, oversight by federal agencies and pass-through entities, and the inherent risk of the federal programs. This risk-based approach and the determination of major programs are discussed in chapter 7.

Low-Risk Auditee

2.17 Circular A-133 contains certain criteria for considering an auditee to be a low-risk auditee. A low risk-auditee is eligible for reduced audit coverage. It should be noted that *low-risk auditee* is a term defined in Circular A-133 for the purpose of applying the percentage-of-coverage rule (see paragraphs 7.24 and 7.25) in the risk-based approach. It does not imply or require the auditor to assess audit risk or any of its components as low for an entity that meets the Circular A-133 definition of a low-risk auditee.

Cluster of Programs

2.18 OMB Circular A-133 defines a cluster of programs as a grouping of closely related federal programs that share common compliance requirements. The types of clusters of programs are R&D, student financial aid (SFA), and other clusters. "Other clusters" are defined by the OMB in the *Compliance Supplement* or are designated as such by a state for the federal awards the state provides to its subrecipients that meet the definition of a cluster of programs. When a state designates federal awards as an "other cluster," it must also identify the federal awards included in the cluster and advise the subrecipients of the compliance requirements applicable to the cluster. A cluster of programs should be considered as one program for determining major programs and (with the exception of R&D), whether a program-specific audit may be elected.

Federal Agency Selection of Additional Major Programs

2.19 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach (described in chapter 7) and, if not, the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon the federal agency request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Auditee Responsibilities

Preparation of Appropriate Financial Statements

2.20 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, the results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with Circular A-133 and prepare separate financial statements (see paragraph 3.25 for a further discussion). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

Summary Schedule of Prior Audit Findings

2.21 The auditee is also required to prepare a summary schedule of prior audit findings. The schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It should also include audit findings reported in the prior audit's summary schedule of prior audit findings, except audit findings that have been corrected or are no longer valid. See paragraphs 10.68 through 10.70 for a further discussion of this schedule.

Other Responsibilities

2.22 In addition to the responsibilities described in paragraphs 2.20 and 2.21, Circular A-133 establishes certain other responsibilities for auditees, including the following:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received, including, as applicable, the CFDA title and number, the award number and year, the name of the federal agency, and the name of the pass-through entity
- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the

auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs

- Complying with laws, regulations, and the provisions of contract or grants agreements related to each of its federal programs
- Ensuring that the audits required by Circular A-133 are properly performed and submitted when due
- Following up and taking corrective action on audit findings (including the preparation of a summary schedule of prior audit findings (see paragraph 2.21) and a corrective action plan (see paragraph 2.26); corrective action should be initiated within six months after the receipt of the audit report and proceed as rapidly as possible

Responsibility for Compliance at the Financial Statement Level and for Internal Control Over Financial Reporting

2.23 Although not specifically stated in Circular A-133, the auditee is also responsible for complying with the requirements of laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on the financial statements and for establishing and maintaining effective internal control over financial reporting. These responsibilities support the requirements of *Government Auditing Standards.*

Reporting Package

2.24 The auditee is also required to submit a reporting package that includes financial statements and a schedule of expenditures of federal awards (see paragraph 2.20 and chapters 4 and 5), the summary schedule of prior audit findings (see paragraph 2.21), the auditor's reports (see paragraph 2.8), and a corrective action plan (see paragraph 2.26). Although not part of the reporting package, the submission of the report must also include the data collection form described in paragraph 2.25. The report submission requirements of Circular A-133 are described in paragraphs 2.9 and 10.74 through 10.79. Auditees must keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse. Furthermore, unless restricted by law or regulation, the auditee is required to make copies of the data collection form and the reporting package available for public inspection.

Data Collection Form

2.25 The auditee is required to complete and sign certain sections of a data collection form which states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. The auditor is also required to complete and sign certain sections of this form. See paragraphs 10.71 through 10.73 for a further discussion of the data collection form.

Corrective Action Plan

2.26 At the completion of the audit, the auditee should prepare a corrective action plan to address each audit finding included in the current year's auditor's reports. See paragraphs 10.68 through 10.70 for a further discussion of the corrective action plan.

Federal Awarding Agency Responsibilities

2.27 For federal agencies that provide federal awards to recipients, Circular A-133 establishes certain responsibilities including the following:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and if the award is for R&D. When some of this information is not available, the federal agency must provide information necessary to clearly describe the federal award
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements
- Ensuring that audits are completed and reports are received in a timely manner and in accordance with the requirements of Circular A-133
- Providing technical advice and counsel to auditees and auditors as requested
- Issuing a management decision on audit findings within six months after receipt of the audit report and ensuring that the recipient takes appropriate and timely corrective action
- Assigning a person to provide annual updates of the *Compliance Supplement* to the OMB

Pass-Through Entity Responsibilities

2.28 Pass-through entities have many responsibilities that are similar to those of federal awarding agencies. See chapter 9 for a detailed description of the responsibilities of pass-through entities.

Cognizant Agency for Audit

Definition

2.29 Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. For recipients expending more than $25 million a year in federal awards, the cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to the recipient unless the OMB makes a specific cognizant agency for audit assignment. The determination of the predominant amount of direct funding is based on the direct federal awards expended by a recipient during its fiscal year ending in 1995, 2000, 2005, and every fifth year thereafter. For example, the audit cognizance for periods ending in 1997 through 2000 will be determined based on the federal awards expended in 1995.[4] Audit cognizance can be reassigned if both the old and the new federal agencies notify the auditee (and, if known, the auditor), of the change within thirty days of the reassignment. A recipient may have one federal agency responsible for audit cognizance and another federal agency responsible for the negotiation of indirect costs.

Responsibilities

2.30 Circular A-133 states that a cognizant agency for audit is responsible for—

- Providing technical audit advice and liaison to auditees and auditors.

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[4] It should be noted that for states and local governments that expend more than $25 million a year in federal awards and have previously assigned cognizant agencies for audit, the requirements in this paragraph are not effective until fiscal years beginning after June 30, 2000.

- Considering auditee requests for extensions to the report submission due date. The cognizant agency for audit may grant extensions for good cause.
- Obtaining or conducting quality control reviews of selected audits made by nonfederal auditors and providing the results, when appropriate, to other interested organizations.
- Promptly informing other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by *Government Auditing Standards* or laws and regulations.
- Advising the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee should work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit must notify the auditor, the auditee, and the applicable federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance by auditors will be referred to appropriate state licensing agencies and professional bodies for disciplinary action.
- Coordinating, to the extent practicable, the audits or reviews made by or for federal agencies that are in addition to audits under Circular A-133, so that the additional audits or reviews build upon the Circular A-133 audits performed.
- Coordinating a management decision for audit findings that affect the federal programs of more than one federal agency.
- Coordinating the audit work and reporting responsibilities among auditors, to achieve the most cost-effective audit.

For biennial audits, the cognizant agency for audit is also responsible for considering auditee requests to qualify as a low-risk auditee.

Oversight Agency for Audit

Definition

2.31 An auditee that does not have a designated cognizant agency for audit that (that is, one that expends $25 million or less in federal awards) will have an oversight agency for audit. Circular A-133 defines the oversight agency for audit as a federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit (see paragraphs 2.29 and 2.30). When there is no direct funding, the federal agency with the predominant indirect funding is required to assume the oversight responsibilities.

Responsibilities

2.32 Circular A-133 describes the duties of oversight agencies for audit. The responsibilities of an oversight agency for audit are not as broad as those of a cognizant agency for audit. However, an oversight agency's primary responsibility is to provide technical advice to auditees and auditors when it is requested. An oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency for audit.

Program-Specific Audits

2.33 Circular A-133 provides general guidance on performing program-specific audits. In many cases, a program-specific audit guide will be available from the federal agency's Office of Inspector General. The audit guide will provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. When a program-specific audit guide is not available, the auditee and auditor have basically the same responsibilities for the federal program as they would have for an audit of a major program in a single audit. Program-specific audits are discussed further in chapter 11.

OMB Circular A-133 Compliance Supplement

2.34 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The *Compliance Supplement* serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133. For the programs included in the *Compliance Supplement*, it provides a source of information for auditors to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. It also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the *Compliance Supplement*. For single audits, the *Compliance Supplement* replaces agency audit guides and other audit requirement documents for individual federal programs.

2.35 The *Compliance Supplement* is effective for audits of fiscal years beginning after June 30, 1996, and supersedes the compliance supplements, *Audits of States and Local Governments* (issued in 1990), and *Audits of Institutions of Higher Education and Other Non-Profit Organizations* (issued in 1991). The *Compliance Supplement* is discussed in greater detail in paragraphs 1.27, 1.28, and 6.21 through 6.30.

Chapter 3

PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF CIRCULAR A-133

3.1 In planning an audit to meet the requirements of Circular A-133, the auditor needs to consider several matters in addition to those ordinarily associated with an audit of financial statements in accordance with GAAS and *Government Auditing Standards*.[1] In this chapter the overall planning considerations in a single audit conducted in accordance with Circular A-133 are discussed. Many of these planning considerations are also applicable in a program-specific audit. Program-specific audits are discussed in detail in chapter 11.

3.2 The following matters are relevant to the planning of a single audit:

- Satisfying Circular A-133 requirements and other relevant legal, regulatory, or contractual requirements (see paragraphs 3.3 through 3.5)
- Establishing an understanding with the auditee (see paragraphs 3.6 and 3.7)
- Satisfying the additional requirements of *Government Auditing Standards* (see paragraphs 3.8 through 3.21)
- Satisfying the additional requirements of the Single Audit Act and Circular A-133 regarding working papers and audit follow-up (see paragraphs 3.22 through 3.24)
- Defining the entity to be audited (see paragraph 3.25)
- Determining the audit period (see paragraphs 3.26 and 3.27)
- Initial-year audit considerations (see paragraphs 3.28 and 3.29)
- The timing of the completion of the audit and reporting submission deadlines (see paragraph 3.30)
- Determining the major programs to be audited (see paragraph 3.31)
- The preliminary assessment of audit risk (see paragraph 3.32)
- Audit materiality considerations (see paragraphs 3.33 through 3.38)
- Determining compliance requirements (see paragraph 3.39)
- Developing an efficient audit approach (see paragraph 3.40)
- Joint audits and reliance on others (see paragraphs 3.41 through 3.44)
- Existence of internal audit function (see paragraph 3.45)
- Communications with the cognizant agency for audit and others (see paragraph 3.46)

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[1] In AICPA *Professional Standards*, AU section 311, "Planning and Supervision," the auditor's responsibilities for planning and supervision in an audit of financial statements in accordance with GAAS are described. Paragraphs 4.6 and 4.7 of *Government Auditing Standards* describe its planning requirements.

- Understanding the applicable state and local compliance and reporting requirements (see paragraphs 3.47 through 3.49)
- Desk reviews and on-site reviews (see paragraphs 3.50 and 3.51)
- The restriction on the auditor's preparation of indirect cost proposals (see paragraph 3.52)
- The exit conference (see paragraphs 3.53 and 3.54)

Satisfying Circular A-133 Requirements and Other Relevant Legal, Regulatory, or Contractual Requirements

3.3 Because of the variety of audit requirements to which entities receiving federal awards are subject, paragraph 21 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21), states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. The auditor should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7 for a further discussion of the establishment of an understanding with the auditee).

3.4 Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.[2] For example, the auditor will be required to make this communication if he or she is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity is also required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*
- The Single Audit Act and Circular A-133
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

3.5 Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the required communication may be oral or written. If the communication is oral, the auditor should document the communication

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[2] For entities that do not have audit committees, "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including their potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts by Clients*, and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit.*

Establishing an Understanding With the Auditee

3.6 SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the auditor should establish an understanding with the auditee regarding the services to be performed. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. The auditor should document this understanding in the working papers, preferably through a written communication with the auditee. If the auditor believes an understanding with the client has not been established, he or she should decline to accept the engagement.

3.7 SAS No. 83 includes a listing of the matters that should generally be included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. In addition to those matters, the auditor should also consider including the following information in the communication when he or she is engaged to perform a single audit:

- A description of the financial statements and supplemental schedule(s) to be audited
- The reporting period
- The auditing standards and requirements that will be followed (for example, GAAS, *Government Auditing Standards*, and Circular A-133)
- The objective of an audit in accordance with Circular A-133
- A description of the reports the auditor is expected to prepare and issue, including any limitation on their use or distribution
- A description of management's responsibility for (*a*) the financial statements and the schedule of expenditures of federal awards; (*b*) internal control over financial reporting and internal control over compliance; (*c*) compliance with laws, regulations, and the provisions of contracts and grant agreements; (*d*) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings and a corrective action plan; and (*e*) submitting the reporting package
- A statement that management has made the auditor aware of significant vendor relationships where the vendor is responsible for program compliance (so that the auditor can determine if additional procedures on vendor records will be necessary—see paragraphs 9.16 and 9.17)
- A description of the auditor's responsibility in an audit of financial statements and in a compliance audit of major programs under Circular A-133, including the determination of major programs, the consideration of internal control, and reporting responsibilities

- Other communications that may arise from the audit
- A description of the working paper retention requirements
- A statement that the working papers will be made available upon request to appropriate federal agencies and the GAO
- The communication with audit committees or other responsible individuals required by *Government Auditing Standards* (see paragraphs 3.19 and 3.20 for a further discussion of this requirement)

SAS No. 83 also states that the establishment of an understanding may be communicated in the form of an engagement letter.

Satisfying the Additional Requirements of *Government Auditing Standards*

3.8 Circular A-133 requires that audits of the financial statements and of the federal awards of the auditee be performed in accordance with *Government Auditing Standards* (see chapter 4 for a further discussion). In an audit in accordance with *Government Auditing Standards*, the auditor has considerations beyond those in a GAAS audit. *Government Auditing Standards* incorporates the fieldwork and reporting standards of GAAS and has general standards (described in chapter 2 of *Government Auditing Standards*) that are similar to those of the AICPA (that is, auditor qualifications, independence, and due professional care). However, *Government Auditing Standards* also contains additional general, fieldwork, and reporting requirements, which are summarized in Table 3.1 and discussed in detail in the three subsequent sections of this chapter.

Table 3.1

Additional Financial Statement Audit
Requirements of *Government Auditing Standards*

General Requirements

- Continuing professional education (CPE) in subjects directly related to the government environment and to government auditing or to the specific or unique environment that the audited entity operates in
- Appropriate internal quality control system and external quality control review every three years

Fieldwork Requirements

- Audit follow-up requirements on known material findings and recommendations from previous audits
- Plan audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts
- Additional working paper requirements

Reporting Requirements

- Communication with audit committees or other responsible individuals
- Referring to *Government Auditing Standards* in the auditor's report
- Reporting on compliance with laws and regulations and on internal controls
- Consideration of privileged and confidential information
- Report distribution

3.9 *Government Auditing Standards* also provides additional guidance on audit materiality, on fraud[3] and illegal acts, and on internal controls. Table 3.2 summarizes where this additional guidance is provided in *Government Auditing Standards* and also where it is discussed in this SOP.

Table 3.2

Additional Guidance in *Government Auditing Standards*

Area of Additional Guidance	Government Auditing Standards *Reference*	*SOP Reference*
Materiality	Paragraphs 4.8 and 4.9	Paragraph 3.34
Fraud and illegal acts	Paragraphs 4.14 through 4.17	Paragraphs 10.21 through 10.25
Internal controls	Paragraphs 4.21 through 4.33	Paragraphs 4.17 and 4.18

General Requirements

Continuing Professional Education

3.10 Government Auditing Standards requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, all auditors (whether certified or not) performing audits in accordance with *Government Auditing Standards* should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of those hours should be completed in each year of the two-year period. For auditors responsible for planning, directing, or reporting on the audit and for auditors conducting substantial portions of the audit, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. If the auditee operates in a specific or unique environment, auditors should receive training that is related to that environment. For example, if the auditor performs an audit of a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the type of not-for-profit organization being audited.

3.11 *Interpretation of Continuing Education and Training Requirements*, a detailed interpretation of the foregoing CPE standards, is available from the GPO (stock number 020-000-00250-6). Among other things, this interpretation discusses who is subject to the CPE requirements and what programs, activities, and subjects qualify as acceptable CPE. During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirements within two years of the start of the first audit in accordance with *Government Auditing Standards*, and every two years thereafter.

Quality Control

3.12 *Government Auditing Standards* also states that the audit organization should have in place an appropriate internal quality control system and

[3] The term *fraud* as used in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, is synonymous with the term *irregularities* as used in *Government Auditing Standards*. Therefore, in discussing the requirements of *Government Auditing Standards*, this SOP will use the term *fraud* instead of the term *irregularities*.

undergo an external quality control review (for example, a peer review). An external quality control review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed.

3.13 *Government Auditing Standards* further requires audit organizations seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* to provide their most recent external quality control review report to the party contracting for the audit. Auditors are not required to provide separate letters of comment. Auditors should consider documenting in the working papers the provision of the quality control review report to the party contracting for the audit.

Fieldwork Requirements

Audit Follow-Up

3.14 *Government Auditing Standards* states that the auditee is responsible for resolving audit findings and recommendations. It further requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. The purpose of this follow-up is to determine whether the auditee has taken timely and appropriate corrective actions. *Government Auditing Standards* also requires auditors to report the status of uncorrected material findings and recommendations that are from prior audits and that affect the financial statement audit. (See paragraphs 3.24, 6.61 through 6.67, and 10.62 for a further discussion of the auditor's responsibility for audit follow-up under both *Government Auditing Standards* and Circular A-133 and how these responsibilities correlate.)

Responsibilities With Regard to the Provisions of Contracts and Grant Agreements

3.15 Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it has generally been interpreted under GAAS that the phrase *laws and regulations* in SAS No. 54 implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

Working Papers

3.16 SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance on the auditor's preparation and maintenance of working papers. *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. This additional standard requires working papers to include sufficient documentation of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records. *Government Auditing Standards* also states that auditors should provide for working paper access to other auditors, to facilitate reviews of audit quality and reliance by other auditors on the auditor's work, and should provide for such access in contractual arrangements for *Government Auditing Standards* audits (see paragraphs 3.22 and 3.23 for a discussion of the working paper access and retention requirements under Circular A-133).

3.17 Audits done in accordance with *Government Auditing Standards* are subject to review by other auditors and by oversight officials more frequently than are audits done in accordance with GAAS. Thus, whereas GAAS cites two main purposes of working papers (providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit), working papers serve an additional purpose in audits performed in accordance with *Government Auditing Standards*. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditor's significant conclusions and judgments.

3.18 *Government Auditing Standards* specifically states that working papers should contain—

- The objectives, scope, and methodology, including any sampling criteria used.
- Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records.[4]
- Evidence of supervisory reviews of the work performed.

Reporting Requirements

Communication With Audit Committees or Other Responsible Individuals

3.19 *Government Auditing Standards* includes an additional reporting standard that requires the auditor to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This standard applies in all situations in which there is an audit committee or the audit is performed under contract. In other situations, the auditor may still find it useful to communicate with management or other officials of the auditee, although it is not required. The auditor should communicate the following information to the audit committee or representatives of the contractor:

a. The auditor's responsibilities in a financial statement audit, including his or her responsibilities for testing and reporting on internal control and compliance with laws and regulations

b. The nature of any additional testing of internal controls and compliance required by laws and regulations

c. The responsibilities and the nature of any additional testing described in items *a* and *b* should be contrasted with other financial related audits of internal control and compliance (to help responsible parties understand the limitations of the auditor's responsibilities for testing and reporting on internal control and compliance)

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[4] Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include in the working papers copies of documents they examined nor are they required to list detailed information from those documents.

3.20 Professional judgment should be used in determining the form and content of the communication, which may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. If written, the required communication may be issued as a separate communication or as part of the auditor's communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7).

Other Additional Reporting Requirements

3.21 The other additional reporting requirements of *Government Auditing Standards*—referring to *Government Auditing Standards* in the auditor's report, reporting on compliance with laws and regulations and on internal control, consideration of privileged and confidential information, and report distribution—are addressed in paragraphs 10.15 and 10.16.

Satisfying the Additional Requirements of the Single Audit Act and Circular A-133 Regarding Working Papers and Audit Follow-Up

Working Papers

3.22 The Single Audit Act states that upon request by a federal agency or the Comptroller General, any independent auditor conducting a single audit should make the auditor's working papers available to the federal agency or the Comptroller General (*a*) as part of a quality review, (*b*) to resolve audit findings, or (*c*) to carry out oversight responsibilities. It also states that access to the auditor's working papers shall include the right to obtain copies. The Single Audit Act intends that federal agencies be judicious in the exercise of this authority and that the release of the working papers should not compromise the confidentiality of proprietary information. The Single Audit Act also intends that any trade secrets and confidential commercial or financial information obtained from the working papers be treated as confidential under the Freedom of Information Act. Auditors should refer to the guidance in the AICPA Auditing Interpretation titled *Providing Access to or Photocopies of Working Papers to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339), when a regulator requests access to the auditor's working papers pursuant to law, regulation, or audit contract.

3.23 Circular A-133 requires that auditors retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor is required to contact the parties contesting the audit finding for guidance prior to the destruction of the working papers and reports.

Audit Follow-Up

3.24 In addition to the requirements of *Government Auditing Standards*, Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 6.61 through 6.67 and 10.62 for a further discussion of the responsibility for audit follow-up under both Circular A-133 and *Government Auditing Standards* and how these responsibilities correlate.)

Defining the Entity to Be Audited

3.25 One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the entity to be audited. Circular A-133 requires that single audits must cover the entire operations of the auditee. However, Circular A-133 provides auditees the option to meet the audit requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units which expended or otherwise administered federal awards during a fiscal year. If an auditee elects this option, then separate financial statements and a schedule of expenditures of federal awards must be prepared for each such department, agency, or other organizational unit. In these circumstances, an auditee's organization-wide financial statements may also include departments, agencies, or other organizational units that have separate audits and prepare separate financial statements. For example, if a local government has its school districts audited separately, it would be acceptable for the local government's financial statements to include the school districts, even though the school districts were not included in the local government's Circular A-133 audit, because a separate Circular A-133 audit was conducted of the school districts. However, if separate financial statements were not prepared for the school districts, it would be unacceptable for a separate Circular A-133 audit to be conducted of the school districts (that is, the local government's organization-wide financial statements could not be used as a substitute for separate financial statements for the school districts). See paragraph 10.34 for a discussion of the situation where the implementation regulations of certain federal agencies define the entity to be audited differently than GAAP.

Determining the Audit Period

Fiscal Year and Program Period May Differ

3.26 An audit performed in accordance with Circular A-133 should cover the auditee's financial transactions (including transactions related to federal awards) for its fiscal year (or a two-year period, if allowed by Circular A-133), which is not necessarily the same as the period of the program being funded (see paragraph 2.5 for further information on biennial audits). Thus, the audit might include only a part of the transactions of a federal award, because some transactions may not occur within the period covered by the audit.

Stub Periods

3.27 Stub periods may occur when an auditee converts from a program-specific audit to a single audit or changes audit periods. One example would be a community college with a September 30 year end that previously had a program-specific audit and is now converting to a single audit. The prior program-specific audits were performed based on a June 30 award year. The first single audit will be for the year ending September 30. This would leave the community college with an unaudited stub period of June 30 to September

30. Arrangements should be made to meet the audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including expenditures of the stub period with the following period's Circular A-133 audit. The cognizant or oversight agency for audit or the pass-through entity should be contacted for advice on how stub periods should be addressed.

Initial-Year Audit Considerations

Preceding Period Audited by Another Auditor

3.28 Whenever an auditor is considering accepting an engagement in which the federal awards of the preceding period were audited by another auditor, he or she should refer to the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). It provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place, and it includes illustrative letters. SAS No. 84 also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.

Factors to Consider Under the Risk-Based Approach

3.29 When the engagement includes the selection of major programs using the risk-based approach, an auditor accepting, or contemplating accepting, an engagement should consider gathering information about the following:

- Federal awards expended by federal program
- Prior-period findings and questioned costs (including the corrective action plan and management decision related to the findings and summary schedule of prior audit findings)
- Whether the predecessor auditor used the exception that allows deviation from the risk-based approach during the last three years (see paragraph 7.20)
- Correspondence from program officials indicating potential problems
- New programs
- Changes to programs
- Amount of funding passed through to subrecipients by individual federal program
- Extent to which computer processing is used to administer federal programs
- Federal programs audited as major programs for the last two years

Timing of the Completion of the Audit and Reporting Submission Deadlines

3.30 When planning the timing of the audit, auditors should be aware that Circular A-133 requires that the audit be completed and the data collection form and reporting package (described in paragraphs 2.24, 2.25, 10.6, 10.7, and 10.71 through 10.73) be submitted to the federal clearinghouse within a certain time period. The timing requirements are discussed in detail in paragraphs 10.74 through 10.79.

Determining the Major Programs to Be Audited

3.31 As discussed in paragraphs 2.16 through 2.19, Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. This determination will affect the scope of the audit and the compliance requirements to be tested. The determination of major programs is discussed further in chapter 7.

Preliminary Assessment of Audit Risk

3.32 As required by SAS No. 54, the auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. While not explicitly stated in SAS No. 54, it has generally been interpreted that the phrase "laws and regulations" implicitly includes provisions of contracts and grant agreements. (Auditors should note that *Government Auditing Standards* explicitly states that the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with the provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statements amounts.) Circular A-133 further requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. In developing an audit plan, the auditor should assess the risk that noncompliance may cause the financial statements to contain a material misstatement or may have a material effect on each major program. Furthermore, the auditor should consider risk factors related to the risk of noncompliance with those laws, regulations, and provisions of contracts and grant agreements and to the related control activities designed to prevent or to detect such noncompliance. As required by SAS No. 82, the auditor should also specifically assess the risk of material misstatement of the financial statements because of error or fraud and should consider that assessment in designing the audit procedures to be performed (see paragraphs 4.32 through 4.37). Audit risk is discussed in greater detail in paragraphs 6.7 through 6.12.

Audit Materiality Considerations

3.33 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor's consideration of materiality when he or she plans and performs an audit of financial statements in accordance with GAAS. Materiality, as it relates to the financial statement audit, is further discussed in the following related AICPA Audit and Accounting Guides:

- *Not-for-Profit Organizations*
- *Audits of State and Local Governmental Units*
- *Health Care Organizations*
- *Audits of Colleges and Universities*[5]

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[5] Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

Materiality Guidance in Government Auditing Standards

3.34 As noted in paragraph 3.9, *Government Auditing Standards* contains guidance on certain areas, including materiality considerations. Paragraphs 4.8 and 4.9 of *Government Auditing Standards* state that "auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions."

Materiality Differences Between the Financial Statement Audit and the Single Audit

3.35 In auditing compliance with requirements governing major programs in accordance with Circular A-133, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with GAAS and *Government Auditing Standards*. In an audit of financial statements, materiality is considered in relation to the financial statements being audited. In designing audit tests and developing an opinion on an auditee's compliance with requirements having a direct and material effect on each major program, however, the auditor considers materiality in relation to each major program (see paragraphs 6.13 through 6.16 for a further discussion of materiality considerations).

Materiality for Purposes of Reporting Audit Findings

3.36 Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs. The auditor should be cautious that this "audit finding" materiality not be confused with (*a*) the materiality used for planning and performing the single audit, (*b*) giving an opinion on the financial statements, and (*c*) giving an opinion on the auditee's compliance with requirements having a direct and material effect on each major program (see paragraph 3.35 above).

3.37 Among other findings that must be reported, Circular A-133 requires the auditor to report material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program in the schedule of findings and questioned costs (other findings that are required to be reported are described in paragraph 10.63). The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement (for example, activities allowed or unallowed, cash management, eligibility, or reporting) for a major program or an audit objective identified in the *Compliance Supplement*.

3.38 For example, when the auditor discovers one or more instances of noncompliance involving the reporting type of compliance requirement for a particular major program, several materiality determinations must be made using professional judgment. First, the auditor must decide whether the noncompliance is material to the reporting type of compliance requirement for the particular major program. If the auditor determines the noncompliance is material to the reporting type of compliance requirement, the noncompliance would be reported as a finding in the schedule of findings and questioned costs. Second, the auditor must decide whether the discovered noncompliance is material, either individually or when aggregated with other noncompliance findings, in relation to the particular major program taken as a whole. If the auditor determines the noncompliance is material to the major program taken as a whole, the auditor would express a qualified or adverse opinion on compliance with respect to the particular major program.

Determining Compliance Requirements

3.39 In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements at the start of the audit (see paragraph 4.27 for a listing of possible audit procedures to assess management's identification of compliance requirements). The auditee and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the CFDA, and previously issued compliance supplements (see paragraph 6.30 for further information).

Developing an Efficient Audit Approach

3.40 Auditors should consider planning and performing a single audit to achieve maximum audit efficiency. Examples of ways to achieve audit efficiency follow.

- The financial statement audit and the single audit could be planned at the same time.
- If the auditee's system administers more than one major program using common internal control, the transactions of those programs could be combined into one population for selecting sample sizes. When testing transactions selected from the major programs, the auditor could use the sample to test internal control over financial reporting, internal control over compliance, and compliance requirements.
- Since Circular A-133 requires the planning and performance of internal control work to assess control risk as low (unless weaknesses are found), the auditor could take advantage of the low assessed level of control risk when he or she performs the substantive testing of compliance.
- Helpful quality control materials (such as planning checklists and reporting checklists) could be used.

Joint Audits and Reliance on Others

3.41 Circular A-133 encourages auditees, whenever possible, to make positive efforts to utilize small business, minority-owned firms, and women's business enterprises. In keeping with the spirit of this provision, certain auditees may engage such independent accounting firms on a joint-venture or subcontract basis. In these instances it may be necessary to refer to the work of other auditors. Prior to entering into an agreement to perform a joint audit or to subcontract with another firm, the auditor should consider SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, and Ethics Interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements.*

3.42 In some circumstances, each of the auditors participating in the single audit will jointly sign the audit reports. This is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signatory of the report.

3.43 If part of the single audit is performed by governmental auditors, the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control standards. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

3.44 Another common occurrence, particularly in a governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component unit included in the financial statements of the reporting entity (see paragraph 3.25). The principal auditor's report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the schedule of expenditures of federal awards, compliance, and internal control related to federal awards, as they relate to federal awards administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

Existence of Internal Audit Function

3.45 Another factor the auditor should consider when planning the single audit is whether the auditee has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with specified requirements. The auditor should consider the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters (for example, in obtaining an understanding of the entity's internal control over financial reporting and compliance, assessing audit risk, and performing substantive procedures).

Communications With the Cognizant Agency for Audit and Others

3.46 When professional judgment indicates it is appropriate, the auditor may communicate with the cognizant agency for audit, the oversight agency for audit, federal awarding agencies, pass-through entities, state auditors, or state awarding agencies, to aid in planning the audit. The auditor might want to consider documenting such communications, as well as any decisions rendered as a result. If a planning meeting is held, matters such as the following may be discussed:

- The audit plan
- The scope of the compliance testing of federal programs
- The intended use of the *Compliance Supplement*
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of expenditures of federal awards
- The testing of the monitoring of subrecipients
- The scope of the review and testing of internal control
- The testing of compliance requirements
- The status of prior-year findings and questioned costs
- Federal agency or pass-through entity management decisions on prior-year findings
- Compliance requirements and any changes to those requirements

Understanding the Applicable State and Local Compliance and Reporting Requirements

Impact on Circular A-133 Audit

3.47 Auditors may be engaged to test and report on compliance with state and local laws and regulations in addition to testing and reporting on the compliance requirements imposed by *Government Auditing Standards* and Circular A-133. For example, there may be state-imposed state award requirements that provide state funds to political subdivisions or NPOs (in this example, the state is not a pass-through entity). Even though such nonfederal awards are not considered part of the total federal awards expended by the auditee and are not subject to audit in accordance with Circular A-133, auditors would still need to consider such laws and regulations under GAAS and *Government Auditing Standards*. Therefore, in connection with the financial statement audit, auditors should obtain an understanding of applicable state and local compliance and reporting requirements that have a direct and material effect on the financial statements being audited.

Compliance Audits of State or Local Grants

3.48 When engaged to audit one or more grants subject to state or local compliance requirements, the auditor should consider performing the following procedures:

- Determine whether the state or local government has a compliance supplement or other audit guide for the program.
- Inquire of management about the additional compliance auditing requirements applicable to the entity.
- Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.

- Obtain any applicable audit guidance from the grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements that is available from state societies of CPAs or associations of governments.
- When appropriate, discuss with the grantor agency the scope of the testing that is expected to be performed.

Compliance Audits Not Involving Governmental Assistance

3.49 Guidance for engagements related to management's written assertion about an entity's compliance with specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500).

Desk Reviews and On-Site Reviews

3.50 In addition to the quality control requirements set forth in *Government Auditing Standards* (see paragraphs 3.12 and 3.13), cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit may also perform these reviews). As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the federal agency. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (See the additional discussion in paragraphs 3.16 and 3.22 regarding working paper access issues.)

3.51 Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the cognizant agency for audit determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances in which the audit was determined to be substandard by the federal agency, the matter may be submitted to state boards of public accountancy.

Restriction on the Auditor's Preparation of Indirect Cost Proposals

3.52 Circular A-133 precludes the auditor who prepares the indirect cost proposal or cost allocation plan from performing the single audit when indirect costs recovered during the prior year by the auditee exceed $1 million. This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998. For example, an auditor who prepares an indirect cost proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 1999, is not permitted to perform the 1999 single audit (assuming that the indirect costs recovered during the prior year exceeded $1 million).

Exit Conference

3.53 Upon completion of fieldwork, the auditor should consider holding a closing or exit conference with senior officials of the auditee. The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions, including whether or not management concurs with the audit findings. This conference also serves to provide the auditee with advance information so that it may initiate corrective action without waiting for a final audit report. In the case of decentralized operations, as at a university, auditors should consider having preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and the administration of sponsored projects.

3.54 The auditor should consider documenting the names of the auditors who conducted the exit conference, the names and positions of the representatives with whom exit conferences were held and any comments that they had, and other details of the discussions.

Chapter 4

FINANCIAL STATEMENT AUDIT CONSIDERATIONS UNDER CIRCULAR A-133

Introduction

4.1 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, their results of operations or changes in net assets, and, where appropriate, their cash flows for the fiscal year. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits and prepare separate financial statements (see paragraph 4.5 below). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

4.2 Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. However, auditees are required to disclose the basis of accounting and significant accounting policies used in preparing the financial statements. Auditees must be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

4.3 Circular A-133 does, however, require the auditor to report whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP). This results in the expression of an opinion or a disclaimer of opinion. (Guidance on reporting on the financial statements of the auditee appears in chapter 10.) If the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP,[1] the auditor is still required to express or disclaim an opinion and should follow the reporting guidance in SAS No. 62, *Special Reports*.

4.4 The financial statements are also required to be audited in accordance with *Government Auditing Standards* (see paragraphs 3.8 through 3.21, 4.17 through 4.19, and 4.41). Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.

4.5 The audit must cover the entire operations of the auditee, or at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and schedule of expenditures of federal awards for each such department, agency, and other organizational unit (see paragraph 3.25 for a further discussion).

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[1] A comprehensive basis of accounting other than GAAP is defined in paragraph 4 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04).

4.6 In performing the financial statement audit, the auditor should refer to the accounting and auditing guidance applicable to specific industries as found in the following AICPA Audit and Accounting Guides: *Not-for-Profit Organizations, Audits of State and Local Governmental Units, Health Care Organizations,* and *Audits of Colleges and Universities.*[2]

4.7 In this chapter, the requirements of GAAS related to the auditor's consideration of compliance and internal control over financial reporting in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* in those areas are discussed.

Consideration of Internal Control Over Financial Reporting

4.8 In the following paragraphs the requirements of GAAS and *Government Auditing Standards* applicable to the auditor's consideration of internal control over financial reporting in a financial statement audit are described.

Summary of GAAS Requirements

4.9 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an auditee's internal control in an audit of financial statements in accordance with GAAS, defines internal control, describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit.

4.10 When obtaining an understanding of internal control over financial reporting and assessing control risk for the assertions embodied in the financial statements, the auditor should refer to SAS No. 55, as amended by SAS No. 78, and to guidance applicable to specific industries as found in the AICPA Audit and Accounting Guides listed in paragraph 4.6.

Definition of Internal Control

4.11 The definition of internal control in both SAS No. 55, as amended by SAS No. 78, and Circular A-133 is consistent with the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The definition is as follows:

> *Internal control* means a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations;
> - Reliability of financial reporting; and
> - Compliance with applicable laws and regulations.

[2] Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

Control Objectives

4.12 The three categories of control objectives described previously are what an auditee strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. In general, controls that are relevant to an audit of financial statements pertain to the auditee's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP (see footnote 1 of this chapter). However, controls pertaining to the operations and compliance objectives may also be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this SOP as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP as "internal control over compliance" and are encompassed in the report on internal control required by Circular A-133 (see paragraphs 10.46 through 10.49). In a particular single audit engagement, some controls may be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Section 505 of Circular A-133 provides guidance on reporting findings involving reportable conditions in internal control in such a circumstance (see paragraph 10.56).

Components of Internal Control

4.13 The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. SAS No. 55, as amended by SAS No. 78, requires the auditor to obtain an understanding of each of those components that is sufficient to plan the audit by performing procedures to understand (*a*) the design of controls relevant to an audit of financial statements, and (*b*) whether they have been placed in operation. In all audits of financial statements, including those audited as part of a single audit, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

Relationship Between Objectives and Components

4.14 There is a direct relationship between the three categories of control objectives (what an auditee strives to achieve) and the control components (what is needed to achieve the objectives). Although an auditee's internal control addresses objectives in each of the categories referred to in the definition of internal control in paragraph 4.11, not all of these objectives and related controls are relevant to an audit of the auditee's financial statements.

Documentation Requirements

4.15 SAS No. 55, as amended by SAS No. 78, requires the auditor to document the understanding of the auditee's internal control components that was obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as by the nature of the auditee's internal control (see paragraphs 3.16 through 3.18 for a discussion of the working paper requirements of *Government Auditing Standards*). Auditors should refer to SAS No. 55, as amended by SAS No. 78, for more detail on the documentation requirements related to internal control over financial reporting.

Communication Requirements

4.16 The auditor should consult the guidance in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for guidance on identifying and reporting conditions that relate to an entity's internal control over financial reporting observed during an audit of financial statements (see also paragraphs 4.19 and 10.26 through 10.30). The auditor should also consult the guidance in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), for required communications to persons who have responsibility for the oversight of the financial reporting process (see also paragraph 10.14).

Responsibilities Under Government Auditing Standards

Fieldwork

4.17 *Government Auditing Standards* does not prescribe any additional fieldwork standards with respect to the auditor's consideration of internal control over financial reporting beyond those required in an audit conducted in accordance with GAAS. However, paragraphs 4.22 through 4.33 of *Government Auditing Standards* provide guidance on four aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. These aspects are summarized as follows:

- *Control environment.* Auditors' judgments about the control environment may influence (either positively or negatively) judgments about specific control procedures.
- *Safeguarding controls.* These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- *Controls over compliance with laws and regulations.* These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.
- *Control risk assessments.* These are important in determining the nature, timing, and extent of the audit tests to be performed. *Government Auditing Standards* reminds auditors that when control risk is

assessed below the maximum for a given financial statement assertion, the need for evidence from substantive tests of that assertion is reduced. Auditors are not required to assess control risk below the maximum and to rely on controls. However, auditors may find it efficient to do so for larger entities or those with complex operations. The auditors' ability to rely on controls is directly related to the evidence obtained to show that the controls work. Auditors may find it necessary to reconsider assessments of control risk when substantive tests detect misstatements.

4.18 The auditor should consider this guidance as it relates to the consideration of the auditee's internal control over financial reporting in the audit of the financial statements.

Reporting

4.19 Reporting on the internal control over financial reporting under *Government Auditing Standards* differs from such reporting under SAS No. 60. *Government Auditing Standards* requires written reporting on internal control over financial reporting in all audits. SAS No. 60 requires communication (either written or oral) only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including the identification of those that are individually or cumulatively material weaknesses. SAS No. 60 permits, but does not require, the auditor to identify and communicate separately, as material weaknesses, those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by SAS No. 60: (*a*) a description of the scope of the auditor's testing of internal control and the results of those tests and (*b*) deficiencies in internal control that are not considered reportable conditions (see the discussion in paragraph 10.29). See paragraphs 3.19 through 3.20 and 10.26 through 10.30 for a more detailed discussion of the reporting requirements related to internal control over financial reporting.

Compliance Considerations

4.20 The auditor should be aware of the unique characteristics of the compliance auditing environment. States, local governments, and not-for-profit organizations differ from commercial enterprises in that they may be subject to diverse compliance requirements. Management is responsible for ensuring compliance with relevant laws and regulations. That responsibility encompasses the identification of applicable laws and regulations and the establishment of internal control designed to provide reasonable assurance that the auditee complies with those laws and regulations.

4.21 In the following paragraphs, the requirements of GAAS that are applicable to the auditor's consideration of compliance in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* are discussed.

Summary of GAAS Requirements

General Guidance

4.22 SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, provides general guidance when the auditor is engaged to audit an entity that receives federal awards, including audits performed under GAAS, *Government Auditing Standards,* and Circular A-133. SAS No. 74 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit and also discusses the auditor's responsibility for compliance auditing related to federal awards in an audit performed under Circular A-133. The auditor's responsibility for compliance auditing related to federal awards is discussed in chapter 6 of this SOP.

4.23 The auditor is required to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations, error, or fraud. SAS No. 54, *Illegal Acts by Clients,* describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit,* and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The requirements of SAS Nos. 54, 82, and 47 are described in paragraphs 4.24 through 4.38.

SAS No. 54 Requirements

4.24 SAS No. 54 requires the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

4.25 Although it has not been explicitly stated in SAS No. 54, the phrase "laws and regulations" has generally been interpreted to implicitly include the provisions of contract and grant agreements (see paragraph 3.15). Laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "compliance requirements." Violations of laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "instances of noncompliance."

4.26 In considering whether the financial statements may be materially misstated because of instances of noncompliance, the auditor should—

- Assess whether management has identified compliance requirements that have a direct and material effect on the determination of amounts in the financial statements.
- Obtain an understanding of the possible effects of these compliance requirements on the determination of financial statement amounts.
- Assess the risk that a material misstatement of the financial statements has occurred because of instances of noncompliance.
- Design and conduct the audit to provide reasonable assurance of detecting such material noncompliance.

4.27 The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and in obtaining an understanding of their possible effects on the determination of financial statement amounts:

a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.

b. Discuss these compliance requirements with the auditee's chief financial officer, legal counsel, or grant administrators.

c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 4.40).

d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.

e. Identify sources of revenue, review any related agreements (for example, loan agreements or grant agreements) and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.

f. Obtain publications pertaining to compliance requirements. These publications often address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.

g. Obtain copies of, and review pertinent sections of, the state constitution, laws, and regulations concerning the auditee. The sections of these documents pertaining to financial reporting, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.

h. Review the minutes of meetings of the governing body of the auditee for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.

i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.

j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Compliance Supplement*, the CFDA, and state and local policies and procedures.

k. Review the guidance contained in the applicable AICPA Audit and Accounting Guides referred to in paragraph 4.6 and review the materials available from other professional organizations, such as state societies of CPAs or industry associations.

l. Inquire of the audit, finance, or program administrators from which grants are received about the restrictions, limitations, terms, and conditions under which such grants were provided. These administrators can usually be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

4.28 In obtaining an understanding of the possible effects on financial statements of compliance requirements that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts, the auditor may consider—

- The materiality of the effect on financial statement amounts.
- The level of management or employee involvement in the compliance-assurance process.
- The opportunity for concealment of instances of noncompliance.

4.29 As part of assessing the risk of material misstatement, the auditor should assess the risk that instances of noncompliance may cause such a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance that are material to the financial statements. Therefore, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from instances of noncompliance that have a direct and material effect on the determination of financial statement amounts (see paragraph 6.53 for a discussion of the impact on the financial statements of actual and projected errors noted in a single audit, and see paragraph 10.42 for a discussion of situations that could occur when the auditor reports on the results of compliance testing).

4.30 Auditees may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug, and price fixing. These laws and regulations generally concern an auditee's operations more than financial reporting and accounting. Their effect on an auditee's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor would not ordinarily have sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the auditee, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.[3]

4.31 If specific information comes to the auditor's attention that provides evidence concerning the existence of possible instances of noncompliance that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an instance of noncompliance occurred. However, because of the characteristics of such noncompliance, an audit made in accordance with GAAS provides no assurance that indirect-effect instances of noncompliance will be detected or that any contingent liabilities that may result will be disclosed.

SAS No. 82 Requirements

4.32 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110), states

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[3] In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, SAS No. 54 notes that, where applicable, the auditor should also inquire of management concerning (*a*) the client's policies relative to the prevention of illegal acts and (*b*) the use of directives issued by the client, as well as periodic representations obtained by the client, from management at appropriate levels of authority, concerning compliance with laws and regulations.

that the auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

4.33 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. These two types of misstatements, as well as the characteristics of fraud, are discussed further in paragraphs 3 through 10 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.03 through 316.10).

4.34 The risk of material misstatement of the financial statements due to fraud is part of audit risk. Therefore, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets in each of the following categories:

Misstatements Arising From Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misstatements Arising From the Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

The auditor should exercise professional judgment when considering (*a*) risk factors individually or in combination and (*b*) whether there are specific controls that mitigate the risk. Risk factors are discussed in greater detail in paragraphs 16 through 25 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU secs. 316.16 through 316.25).

4.35 As noted previously, an auditor's interest specifically relates to fraudulent acts that cause a material misstatement in the financial statements. When the auditor is identifying risk factors and other conditions in an audit of financial statements performed in conjunction with a single audit, the auditor's responsibilities under SAS No. 82 are expanded to include (in addition to the risk factors normally associated with financial statements) the consideration of risk factors associated with the receipt of federal awards that could present a material misstatement of the financial statements. Auditors may wish to refer to the AICPA practice aid titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which includes specific nonauthoritative guidance on applying the concepts of SAS No.

82 to several industries, including government, health care, and not-for-profit organizations. Among other things, it identifies example risk factors for those industries, including risk factors that relate to recipients of federal awards.

4.36 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Where risk factors are identified as being present, the documentation should include (*a*) those risk factors identified and (*b*) the auditor's response to those risk factors, individually or in combination. In addition, if, during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required, these risk factors or other conditions, as well as any further response that the auditor concluded was appropriate, should also be documented.

4.37 SAS No. 82 also contains requirements on the auditor's response to the results of the assessment of risk, the evaluation of audit test results, and communications about fraud to management, the audit committee, and others. Auditors should refer to SAS No. 82 for a description of the specific requirements in those areas (see also paragraphs 10.18 through 10.20).

SAS No. 47 Requirements

4.38 SAS No. 47, as amended by SAS No. 82, provides guidance to auditors in fulfilling the responsibility described in paragraph 4.32, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (*a*) mistakes in gathering or processing data from which financial statements are prepared, (*b*) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (*c*) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles is generally not significant to the audit. In contrast, when fraud is detected, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. Auditors should refer to SAS No. 47 for more detailed guidance.

Working Paper Documentation

4.39 The auditor should document the procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 41, *Working Papers*. (See paragraphs 3.16 through 3.18 of this SOP for a discussion of the *Government Auditing Standards* requirements related to working papers.) The fraud risk factors identified and the auditor's response to those risk factors should be documented in accordance with SAS No. 82 (see paragraph 4.36). The auditor's understanding of internal control over financial reporting as it pertains to compliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with SAS No. 55, as amended by SAS No. 78 (see paragraph 4.15).

Written Representations From Management

4.40 SAS No. 85, *Management Representations*, requires the auditor to obtain written representations from management as part of an audit conducted in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to compliance requirements affecting the financial statement audit, auditors should consider obtaining additional representations from management acknowledging that management (see paragraphs 6.68 and 6.69 for a discussion of additional management representations in a single audit)—

a. Is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.

b. Is responsible for establishing and maintaining effective internal control over financial reporting.

c. Has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.

d. Has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

Additional Responsibilities Under Government Auditing Standards

4.41 *Government Auditing Standards* prescribes as part of the financial statement audit additional fieldwork and reporting requirements beyond those in GAAS that are related to compliance. The additional fieldwork responsibilities are related to audit follow-up on known material findings and recommendations from previous audits, as well as to working paper access and documentation. (See paragraphs 3.14 through 3.18 of this SOP for a further discussion of these requirements.) With regard to reporting, *Government Auditing Standards* requires, among other things, that the auditor report on the scope of his or her testing of compliance and present the results of those tests. See paragraphs 10.15 and 10.16 for a more detailed discussion of the *Government Auditing Standards* reporting requirements related to compliance.

Reasonable Assurance

4.42 SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), states that since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (*a*) failure to obtain reasonable assurance, (*b*) inadequate planning, performance, or judgment, (*c*) the absence of due professional care, or (*d*) a failure to comply with GAAS.

Chapter 5

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Overview of Schedule Requirements

5.1 Circular A-133 requires the auditor to determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. This schedule, prepared by the auditee, reports the total expenditures for each federal program (see paragraph 1.18 for the Circular A-133 definition of federal programs). In this chapter the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds are described. The auditor's reporting on the schedule is discussed in paragraphs 10.36 and 10.37.

Identification of Federal Awards

Federal Agency and Pass-Through Entity Requirements

5.2 Circular A-133 requires federal agencies and pass-through entities to identify the federal awards made by informing each recipient or subrecipient of the CFDA title and number, the award's name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency or pass-through entity is required to provide the information necessary to describe the federal award clearly.

Auditee Requirements

5.3 Circular A-133 also requires the auditee to identify in its accounts all federal awards received and expended, as well as the federal programs under which they were received. Federal program and award identification includes, as applicable, the CFDA title and number, the award number and year, the name of the federal granting agency, and the name of the pass-through entity.

Auditor Assessment of Auditee Identification of Federal Programs

5.4 In assessing the appropriateness and completeness of the auditee's identification of federal programs in the schedule, the auditor should consider, among other matters, evidence obtained from audit procedures performed to evaluate the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or pass-through entities in an audit of a subrecipient. When the auditee is unable to identify federally funded expenditures separately, the auditor should consider whether a reportable condition exists. If it does, a finding should be reported in the schedule of findings and questioned costs (see chapter 10 for a further discussion of reporting findings and the schedule of findings and questioned costs).

General Presentation Requirements

Basis of Accounting

5.5 Circular A-133 does not prescribe the basis of accounting that must be used by the auditee to prepare the schedule of expenditures of federal awards. Some auditees may choose to prepare the schedule on a basis of accounting that is different from that in the financial statements. In any case, the auditee is required to disclose the basis of accounting and the significant accounting policies used in preparing the schedule. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

Required Schedule Contents

5.6 Circular A-133 requires the auditee to prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum, the schedule should—

- List individual federal programs by federal agency. For federal programs included in a cluster of programs (see paragraphs 1.18, 1.19, and 2.18), list individual federal programs within a cluster of programs. For R&D, the total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services (the federal agency).
- Include, for federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Provide the total federal awards expended for each individual federal program and the CFDA number or other identifying number when the CFDA information is not available.
- Include notes that describe the significant accounting policies used in preparing the schedule.
- Identify, to the extent practical, the total amount provided to subrecipients by pass-through entities from each federal program (see chapter 9 for a further discussion of the audit considerations of federal pass-through awards).
- Include, in either the schedule or a note to the schedule, the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end (see paragraph 5.13).

Example schedules of expenditures of federal awards appear in appendix C.

Providing Additional Information

5.7 Although not required, the auditee may choose to provide other information (in addition to the foregoing requirements) that is requested by federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a federal program has multiple award years, the auditee may choose to list the amount of federal awards expended for each award year separately, if so requested by a federal agency.

Schedule Not in Agreement With Other Federal Award Reporting

5.8 Auditors should note that the information included in the schedule may not fully agree with other federal award reports that the auditee submits directly to federal granting agencies because, among other reasons, the award reports (*a*) may be prepared for a different fiscal period and (*b*) may include cumulative (from prior years) data rather than data for the current year only.

Inclusion of Nonfederal Awards

5.9 Circular A-133 does not require nonfederal awards (for example, state awards) to be presented in the schedule. However, to meet state or other requirements, auditees may decide to include such awards in the schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

CFDA Number Not Available

5.10 The auditee may be unable to obtain the CFDA number, which is sometimes the case for new federal programs and R&D programs. In addition, cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the auditee should indicate that fact and should include in the schedule the program's name and, if available, other identifying number.

Pass-Through Awards

Treatment of Pass-Through Awards

5.11 Circular A-133 defines a subrecipient as an entity that expends federal awards that are received from a pass-through entity to carry out a federal program. State or local government redistributions of federal awards to subrecipients, known as "pass-through awards," should be treated by the subrecipient as though they were received directly from the federal government. Accordingly, pass-through awards should be included in the scope of the single audit on the same basis as that of federal awards that are received directly. The audit considerations of federal pass-through awards are discussed further in chapter 9. As noted in paragraph 5.6, in addition to the other general presentation requirements, Circular A-133 requires the schedule to include the name of the pass-through entity and the identifying number assigned by the pass-through entity for federal awards received as a subrecipient.

Commingled Assistance

5.12 The individual sources (that is, federal, state, and local) of federal awards may not be separately identifiable because of commingled assistance from different levels of government. If the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule, with a footnote describing the commingled nature of the funds.

Noncash Awards

Treatment of Noncash Awards

5.13 Most federal awards are in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions. These programs may include food stamps, commodities, loan guarantees, loans, surplus property, interest rate subsidies, or insurance. Circular A-133 requires the value of federal awards expended in the form of noncash assistance (such as loan guarantees, loans, insurance programs, surplus property, food stamps issued, or commodities distributed) to be reported either on the face of the schedule or disclosed in the notes to the schedule. The OMB states in Circular A-133 that although it is not required, it is preferable to present this information in the schedule rather than in the notes to the schedule. See paragraphs 2.13 and 2.14 for a discussion on determining when awards, including noncash awards, are considered to be expended.

Determining the Value of the Noncash Awards Expended

5.14 Table 5.1 shows the bases generally used to determine the value of noncash awards expended (see section 205 of Circular A-133 for additional details).

Loan and Loan Guarantee Continuing Compliance Requirements

5.15 As noted previously, in determining the value of total noncash awards expended for loans and loan guarantees, the balances of loans from previous years must be included if the federal government imposes continuing compliance requirements. Circular A-133 does not specifically define the term *continuing compliance requirements*. Therefore, it is a matter of judgment as to whether continuing compliance requirements are significant enough to require inclusion of prior-year loan or loan guarantee balances. For example, if in a prior year an auditee expended the proceeds of a federal loan to construct a building, and the current-year activity consists only of loan repayments and a requirement by the federal lender for the auditee to submit a report that only details loan payment information, it may not be necessary to include the prior year's loan balance in determining the total amount of loans expended. However, if the federal lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income residents, it would likely be necessary to include the prior year's loan balance in determining the total amount of loans expended. The auditor should consider contacting the federal agency Office of Inspector General for assistance in determining whether continuing compliance requirements are significant enough to require inclusion of the balances of prior loans or loan guarantees.

Table 5.1

Determining the Value of Noncash Awards Expended

Types of Noncash Awards	*Basis Used to Determine the Value of Noncash Awards Expended*
Loans and loan guarantees*	Value of new loans made or received during the fiscal year plus the balance of loans from previous years for which the federal government imposes continuing compliance requirements (see paragraph 5.15), plus any interest subsidy, cash, or administrative cost allowance received.
Loans and loan guarantees (loans) at institutions of higher education*	When loans are made to students but the institution of higher education does not make the loans, only the value of loans made during the year are considered federal awards expended. The balance of loans for previous years is not included because the lender accounts for the prior balances.
Insurance	Fair market value of insurance contract at the time of receipt, or the assessed value provided by the federal agency.
Food stamps	Fair market value of food stamps at the time of receipt, or the assessed value provided by the federal agency.
Commodities	Fair market value of commodities at the time of receipt, or the assessed value provided by the federal agency.
Donated property or donated surplus property	Fair market value of donated property or donated surplus property at the time of receipt, or the assessed value provided by the federal agency.
Free rent	Fair market value of free rent at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program.

* The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

Endowment Funds

5.16 Circular A-133 states that the cumulative balance of federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

Chapter 6

COMPLIANCE AUDITING APPLICABLE TO MAJOR PROGRAMS

6.1 In this chapter the auditor's consideration of compliance requirements applicable to major programs in a single audit under Circular A-133 is discussed (as noted in paragraph 11.5, much of the guidance in this chapter would also be applicable to a program-specific audit when a program-specific audit guide is not available). The consideration of internal control over compliance for major programs is discussed in chapter 8. The related reporting requirements are discussed in chapter 10. The auditor's consideration of the auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements in a financial statement audit is discussed in chapter 4.

Single Audit Compliance Objectives

6.2 In addition to a financial statement audit in accordance with GAAS and *Government Auditing Standards,* Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (these are hereinafter referred to as "compliance requirements"). A single audit results in the auditor expressing an opinion on the auditee's compliance with these compliance requirements for each of its major programs. To express such an opinion, the auditor accumulates sufficient evidence by planning and performing tests of transactions and such other auditing procedures as are necessary in support of the entity's compliance with applicable compliance requirements, thereby limiting audit risk to an appropriately low level.

Responsibilities of Auditee

6.3 The auditee is responsible (*a*) for complying with the compliance requirements related to each of its federal programs and (*b*) for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. The auditor should obtain management's written representations regarding its compliance and internal control responsibilities as discussed in paragraphs 6.68 and 6.69.

6.4 The form and extent of the documentation of management's compliance will vary depending on the nature of the compliance requirements and the size and complexity of the entity. The auditee may have documentation in the form of accounting or statistical data, case files, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.

Use of Professional Judgment

6.5 The planning, conduct, and evaluation of the results of compliance testing in a single audit require the auditor to exercise professional judgment. The following factors may be considered by the auditor in applying his or her professional judgment:

- The assessment of inherent risk, control risk, and fraud risk
- The assessment of materiality
- The evidence obtained from other auditing procedures
- The amount of expenditures for the program
- The diversity or homogeneity of expenditures for the program
- The length of time that the program has operated, or changes in its conditions
- The current and prior auditing experience with the program, particularly findings in previous audits and other evaluations (that is, inspections, program reviews, or system reviews required by the federal acquisition regulations)
- The extent to which the program is carried out through subrecipients, as well as the related monitoring activities
- The extent to which the program contracts for goods or services
- The level to which the program is already subject to program reviews or other forms of independent oversight
- The expectation of noncompliance or compliance with the applicable compliance requirements
- The extent to which computer processing is used to administer the program, as well as the complexity of the processing
- Whether the program has been identified as being high-risk by the OMB in the *Compliance Supplement*

Audit Risk Considerations

6.6 To express an opinion on compliance, the auditor accumulates sufficient evidence in support of compliance, thereby limiting audit risk to an appropriately low level. The auditor's consideration of audit risk and materiality when he or she plans and performs a single audit is similar to the consideration in a financial statement audit in accordance with SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Components of Audit Risk

6.7 Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance. It is composed of inherent risk, control risk, fraud risk, and detection risk. For the purposes of a single audit, these components are defined as follows:

- *Inherent risk*—the risk that material noncompliance with a major program's compliance requirements could occur, assuming there is no related internal control

- *Control risk*—the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the entity's internal control
- *Fraud risk*—the risk that intentional material noncompliance with a major program's compliance requirements could occur
- *Detection risk*—the risk that the auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major program does not exist when, in fact, such noncompliance does exist

In paragraphs 6.8 through 6.12, each of these components of audit risk is discussed and an explanation of how the components of audit risk interrelate in providing a basis for the auditor's opinion on compliance is given.

Inherent Risk

6.8 In assessing inherent risk, the auditor should consider factors that are relevant to compliance engagements. Such factors include the following (the factors listed in paragraph 6.5 should also be considered):

- The complexity of the compliance requirements
- The length of time the entity has been subject to the compliance requirements
- Prior experience with the entity's compliance
- The potential impact of noncompliance, both qualitatively and quantitatively

6.9 The auditor's assessment of inherent risk over major programs may be performed in part when the auditor is determining major programs using the risk-based approach (see paragraph 7.36). The nature of some programs may indicate higher inherent risk. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides the following examples for program characteristics with potentially higher inherent risks:

- Complex programs and the extent to which a program contracts for goods and services have the potential for higher risk. For example, federal programs that disburse funds through third-party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high risk for time-and-effort reporting but may otherwise be at low risk.
- The phase of a federal program's life cycle at the federal agency may indicate risk. For example, a new program with new or interim regulations may have a higher risk than an established program with time-tested regulations. In addition, significant changes in federal programs, laws, or regulations or in the provisions of contracts or grant agreements may increase risk.
- The phase of a program's life cycle at the auditee may indicate risk. For example, during the first and last years in which an auditee participates in a program, the risk may be higher because of the start-up or closeout of the program's activities and staff.
- Type B programs with larger federal awards expended would be of higher risk than would programs with substantially smaller federal awards expended.

Control Risk

6.10 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs, to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The circular does not, however, actually require the achievement of a low assessed level of control risk. The assessment of control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major program. The process of assessing control risk (together with assessing inherent risk and fraud risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for his or her opinion on compliance. The auditor's consideration of internal control over compliance for major programs, including the assessment of control risk, is discussed in chapter 8.

Fraud Risk

6.11 SAS No. 82 provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud (see paragraphs 4.32 through 4.37). Because SAS No. 82 only applies to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Auditors may wish to refer to the AICPA practice aid titled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which identifies example risk factors that relate to recipients of federal awards. When the auditor has assessed fraud risk and has deemed that a further response is necessary, the guidance in paragraphs 26 through 32 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.26–.32) may be helpful.

Detection Risk

6.12 In determining an acceptable level of detection risk, the auditor considers his or her assessments of inherent risk, control risk, and fraud risk, and the extent to which he or she seeks to restrict the audit risk related to the major program. As assessed inherent risk, control risk, or fraud risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the compliance tests performed based on the assessments of inherent risk, control risk, and fraud risk. Circular A-133 states that compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance. Such compliance testing serves to limit detection risk.

Materiality Considerations

6.13 In a compliance audit, the auditor's consideration of materiality differs from that in an audit of financial statements (see paragraphs 3.33 through

3.38). Materiality is affected by (*a*) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms, (*b*) the nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and (*c*) qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities. Qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (*a*) a low risk of public or political sensitivity, (*b*) a single exception that has a low risk of being pervasive, or (*c*) an indication, based on the auditor's judgment and experience, that the affected federal agency or pass-through entity would normally not need to resolve the finding or take follow-up action.

Materiality Judgments About Compliance Applied to Each Major Program Taken as a Whole

6.14 In designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

6.15 For purposes of evaluating the results of compliance testing, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by law, regulation, contract, or grant that results in an aggregation of noncompliance (that is, the auditor's best estimate of the overall noncompliance) that is material to the affected federal program. It should be noted that several instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one audit to the next.

Effect of Material Noncompliance on the Financial Statements

6.16 If the tests of compliance reveal material noncompliance at the major program level, the auditor should consider its effect on the financial statements. The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. (See also paragraphs 6.53 and 10.42.)

Performing a Compliance Audit

6.17 The auditor should exercise (*a*) due care in planning and performing the audit and in evaluating the results of his or her audit procedures, and (*b*) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

6.18 In performing compliance tests, the auditor should—

a. Identify the auditee's major programs to be tested and reported on for compliance (paragraph 6.19 and chapter 7).

b. Identify the applicable compliance requirements (paragraphs 6.20 through 6.30).

c. Plan the engagement (paragraphs 6.31 through 6.34 and chapter 3).

d. Consider relevant portions of the entity's internal control over compliance for major programs (paragraph 6.35 and chapter 8).

e. Obtain sufficient evidence, which involves testing compliance with applicable compliance requirements (paragraphs 6.36 through 6.47).

f. Consider subsequent events (paragraphs 6.48 through 6.50).

g. Form an opinion about whether the auditee complied with the applicable compliance requirements (paragraphs 6.51 through 6.60).

h. Perform follow-up procedures on previously identified findings (paragraph 6.61 through 6.67).

Identifying Major Programs to Be Tested

6.19 Circular A-133 requires the auditor to determine the major programs to be tested in a single audit using a risk-based approach. The application of the risk-based approach to determine major programs is discussed in chapter 7.

Identifying Applicable Compliance Requirements

6.20 The auditor must determine the applicable compliance requirements to be tested and reported on in a single audit (that is, those laws, regulations, and provisions of contracts or grant agreements that may have a direct and material effect on each major federal program). The auditor should use professional judgment in making this determination.

Compliance Supplement

6.21 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits (see paragraphs 1.27 through 1.29, 2.34, and 2.35 for additional discussion of the *Compliance Supplement* and for instructions on how to obtain a copy). The *Compliance Supplement* identifies the fourteen types of compliance requirements applicable to most federal programs. It also includes the compliance requirements specific to certain of the largest federal programs. Part 7 of the *Compliance Supplement* provides guidance to assist the auditor in identifying the compliance requirements for federal programs not included in the *Compliance Supplement* (see also paragraph 6.30).

Fourteen Types of Compliance Requirements

6.22 Part 3 of the *Compliance Supplement* lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted under Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program specific audit guide (see paragraph 11.4). Suggested audit procedures are also provided to assist the auditor in planning and performing tests of the auditee's compliance with the requirements of federal programs. The auditor's judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives and whether additional or alternative audit procedures are needed (see paragraph 6.44). The fourteen types of compliance requirements are as follows:

- A—activities allowed or unallowed
- B—allowable costs/cost principles
- C—cash management
- D—Davis-Bacon Act
- E—eligibility
- F—equipment and real property management
- G—matching, level of effort, earmarking
- H—period of availability of federal funds
- I—procurement and suspension and debarment
- J—program income
- K—real property acquisition and relocation assistance
- L—reporting
- M—subrecipient monitoring
- N—special tests and provisions

The auditor should consider the applicability of these compliance requirements to the auditee's major programs. Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor for this purpose by identifying whether particular compliance requirements apply to the federal programs included in the *Compliance Supplement*. In making a determination not to test a compliance requirement identified as applicable to a particular program, the auditor must conclude either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a material effect on a major program.

Keeping Abreast of Changes in Compliance Requirements

6.23 Circular A-133 states that an audit of the compliance requirements related to federal programs contained in the *Compliance Supplement* will meet the requirements of the circular. However, it also states that when there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, the auditor must determine the current compliance requirements and modify the audit procedures accordingly.

6.24 Although Circular A-133 provides that federal agencies are responsible to inform the OMB annually of any updates needed to the *Compliance Supplement*, the auditor should recognize that laws and regulations change periodically and that delays will occur between such changes and revisions to the *Compliance Supplement*. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current. Besides describing the compliance requirements, the *Compliance Supplement* includes references to the Code of Federal Regulations and other sources of information about the requirements. The auditor may refer to those other sources of information to identify significant changes to the requirements or perform other procedures, including the following:

- Discussions with appropriate individuals within the auditee organization (that is, the chief financial officer, internal auditors, legal counsel, the compliance officer, or grant or contract administrators)
- A review of contracts or grant agreements, new guidance material issued by the granting agency or pass-through entity (for example, handbooks and operating procedures), and correspondence from the granting agency or pass-through entity

- An inquiry of granting agency personnel (appendix III of the *Compliance Supplement* includes a listing of federal agency contacts, including addresses, phone numbers, and E-mail or Web page addresses that could be useful if the auditor decides to make such an inquiry)

Considering Additional Provisions of Contracts or Grant Agreements

6.25 The *Compliance Supplement* states that in addition to the compliance requirements identified in the supplement, auditors need to consider whether there are any provisions of contracts or grant agreements that are unique to a particular entity (for example, the grant agreement may specify the matching percentage, or an entity may have agreed to additional requirements that are not required by law or regulation, perhaps as part of a resolution of prior audit findings).

6.26 Therefore, in using the *Compliance Supplement* to identify applicable compliance requirements, the auditor needs to consider—

a. The applicability to the federal program of the fourteen types of compliance requirements identified in part 3 of the *Compliance Supplement.*

b. Additional compliance requirements specific to the federal program as identified in part 4 of the *Compliance Supplement.*

c. Any provisions of contracts or grants that are unique to the particular entity.

Compliance Requirements Specific to Certain Federal Programs

6.27 Part 4 of the *Compliance Supplement* discusses program objectives, program procedures, and compliance requirements that are specific to each federal program included. With the exception of special tests and provisions, the auditor should refer to part 3 of the *Compliance Supplement* for the audit objectives and suggested audit procedures that pertain to the compliance requirements associated with each program. Since special tests and provisions are unique to each program, the audit objectives and suggested audit procedures for each program are included in part 4.

Compliance Requirements Specific to a Cluster of Programs

6.28 As noted in paragraph 2.18, a cluster of programs is a grouping of closely related programs that have similar compliance requirements (for example, SFA, R&D, and other clusters). Part 5 of the *Compliance Supplement* identifies those programs that are considered to be clusters of programs. It also provides compliance requirements, audit objectives, and suggested audit procedures for the clusters.

Relationship of the Compliance Supplement *to Federal Program Audit Guides*

6.29 The *Compliance Supplement* states that for single audits, the supplement replaces federal agency audit guides and other audit requirement documents for individual federal programs.[1] Accordingly, for a federal program

[1] Auditors should note that two federal agencies, the Department of Housing and Urban Development and the Department of Education have issued interim supplements to address the requirements of certain agency programs. Those supplements provide guidance similar to that provided in part 4 of the *Compliance Supplement*. A description of the supplements and the authoritative status of each are discussed in part 1 of the *Compliance Supplement*. Auditors should refer to the *Compliance Supplement* to determine whether to use the interim supplements or the *Compliance Supplement* for the federal programs included in the supplements. As of the date of this SOP, the OMB has indicated that the federal programs included in the Department of Education interim supplement will be included in the next revision of the *Compliance Supplement*.

included in the *Compliance Supplement* and having a separate federal program audit guide or other federal program audit requirement documents, the auditor needs to consider only those compliance requirements in the *Compliance Supplement* when performing a single audit (versus a program-specific audit).

Federal Programs Not Included in the Compliance Supplement

6.30 The *Compliance Supplement* does not include all federal programs from which an auditee may receive federal awards. Circular A-133 states that for those federal programs not covered in the *Compliance Supplement*, the auditor should use the fourteen types of compliance requirements (see paragraph 6.22) contained in the supplement as guidance for identifying the types of compliance requirements to test, and should determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements. The auditor should follow the guidance in part 7 of the *Compliance Supplement* for identifying the applicable compliance requirements to test and report on in a single audit. That guidance outlines the following steps to determine which compliance requirements to test:

a. Identify the applicable compliance requirements for the federal program.

b. Determine which of the compliance requirements identified in step *a* could have a direct and material effect on the major program.

c. Determine which of the compliance requirements identified in step *b* are susceptible to testing by the auditor.

d. Determine which of the fourteen types of compliance requirements would the compliance requirements identified in step *c* fall into.

e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the *Compliance Supplement* provides more detailed guidance on the steps to perform to identify applicable compliance requirements.

Planning the Engagement

General Considerations

6.31 Planning a compliance audit involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, auditors need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance. Proper planning and supervision contribute to the effectiveness of audit procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

6.32 Factors to be considered by the auditor in planning a compliance audit include (*a*) the anticipated level of audit risk related to the compliance requirements on which the auditor will report (see paragraphs 6.6 through 6.12), (*b*) preliminary judgments about materiality levels for audit purposes (see paragraphs 6.13 through 6.16), and (*c*) conditions that may require extension or modification of audit procedures.

6.33 The nature, timing, and extent of planning will vary with the nature and complexity of the compliance requirements and the auditor's prior experience with the auditee. As part of the planning process, the auditor should consider the nature, timing, and extent of the work to be performed to accomplish the objectives of the compliance audit. Nevertheless, as the compliance audit progresses, changed conditions may make it necessary to modify planned procedures. For discussion of additional planning considerations, see chapter 3.

Multiple Components

6.34 In a compliance audit in which the auditee has operations in several components (for example, locations or branches), the auditor may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the auditor should consider such factors as the following: (*a*) the degree to which the specified compliance requirements apply at the component level, (*b*) judgments about materiality, (*c*) the degree of centralization of the records, (*d*) the effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others, as well as its ability to supervise activities at various locations effectively, (*e*) the nature and extent of operations conducted at the various components, and (*f*) the similarity of operations and controls over compliance for different components. See paragraph 8.13 for a discussion of internal control considerations for multiple components.

Consideration of Internal Control Over Compliance for Major Programs

6.35 The auditor should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the audit and to assess control risk for compliance with specified requirements. In planning the audit, the auditor should use this knowledge to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance. Circular A-133 specifically requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Circular A–133 also requires the auditor to perform testing of controls as planned. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls (see paragraph 3.40). Any reportable conditions in internal control over compliance for major programs that are noted are required to be reported as an audit finding (see paragraph 10.63). Control risk is discussed further in paragraph 6.10, and the auditor's consideration of internal control over compliance for major programs (including the final control risk assessment and the performance of tests of controls) is discussed in more detail in chapter 8.

Performing Compliance Testing

6.36 Circular A-133 requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed (*a*) concurrently with tests of controls, (*b*) as substantive testing, or (*c*) as a combination of the two. In performing compliance testing, the auditor attempts to obtain reasonable assurance that the auditee complied, in all material respects, with the compliance requirements. This includes designing the compliance audit to detect both intentional and unintentional noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the auditor is persuasive rather than conclusive in nature. Furthermore, procedures that are effective for detecting unintentional noncompliance may be ineffective for detecting noncompliance that is intentional and is concealed through a collusion between the client's personnel and third parties or among the management or employees of the client. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

6.37 In determining the nature, timing, and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying his or her judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence. In determining the nature, timing, and extent of the testing of an auditee's compliance with compliance requirements, the auditor should consider audit risk and materiality related to each major program. The auditor plans compliance tests to reduce detection risk to an acceptable level. The evidence provided by these tests, along with evidence regarding inherent risk and control risk, provides the basis for expressing an opinion on whether the auditee complied, in all material respects, with the compliance requirements for each major program.

6.38 In determining the nature of his or her tests of compliance with requirements governing major programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management expended the funds.

Sufficient Evidence

6.39 The auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. The selection and application of procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for expressing an opinion on compliance require the careful exercise of professional judgment. A broad array of available procedures may be applied in a compliance audit. In establishing a proper combination of procedures to restrict audit risk appropriately, the auditor should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

a. Evidence obtained from independent sources outside an entity provides greater assurance of an entity's compliance than evidence secured solely from within the entity.

b. Information obtained from the auditor's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.

c. The more effective the internal control, the greater the assurance it provides about the entity's compliance.

6.40 Thus, in the hierarchy of available audit procedures, those that involve search and verification (for example, inspection, confirmation, or observation)—particularly when independent sources outside the entity are used—are generally more effective in reducing audit risk than are those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with the individuals responsible for compliance).

6.41 In a compliance audit, the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance being provided. An auditor should select from all available procedures (that is, procedures that assess inherent, control, and fraud risk and restrict detection risk)—any combination that can limit audit risk to such an appropriately low level.

6.42 For regulatory requirements, the auditor's procedures may include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Audit Objectives

6.43 As noted in paragraph 6.22, the *Compliance Supplement* contains the audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements. The audit objectives are useful in understanding the specific objectives to be satisfied when the auditor performs audit tests and determines whether the noncompliance that is identified is material.

Suggested Audit Procedures

6.44 The *Compliance Supplement* contains suggested audit procedures for testing federal programs for compliance. These suggested audit procedures represent procedures that may be used by the auditor in developing an audit program. The suggested audit procedures may also be useful in testing the same types of compliance requirements for programs that are not included in the *Compliance Supplement*. These suggested audit procedures represent a tool available to the auditor; however, the auditor is neither required to follow these audit procedures nor restricted to using only these procedures. The auditor should use professional judgment in determining the appropriate audit procedures to be performed to allow him or her to obtain sufficient evidence to form an opinion on the auditee's compliance with the compliance requirements that could have a direct and material effect on each major program.

Audit Sampling

6.45 The auditor generally uses audit sampling to obtain evidential matter. There are two approaches to audit sampling: nonstatistical and statistical. Circular A-133 does not require any particular sampling approach in a single audit. The factors to be considered in planning, designing, and evaluating audit samples (including planning a particular sample for a test of controls) are discussed in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards,* vol. 1, AU sec. 350). When planning to test a particular sample of transactions, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. Auditors should note that SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and Circular A-133 require the auditor to determine both the known questioned costs and likely questioned costs associated with audit findings. The determination of likely questioned costs may require the projection of sample results to determine whether a finding is required to be reported in the schedule of findings and questioned costs. Circular A-133 does not require the auditor to report an exact amount or a statistical projection of likely questioned costs, but rather to include an audit finding when the auditor's estimate of likely questioned costs is greater than $10,000. See paragraph 6.59 for a further discussion of likely questioned costs.

6.46 The AICPA Audit and Accounting Guide *Audit Sampling* provides guidance to help auditors apply audit sampling in accordance with SAS No. 39. In the Audit Guide, sampling in compliance tests of internal controls and in substantive tests of details, as well as dual-purpose testing is discussed.

Using Separate Samples for Each Major Program

6.47 Although the auditor must obtain sufficient evidence to support an opinion on compliance for each major federal program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance. As noted in paragraph 6.37, the auditor should be aware that a sample of a few items with a low dollar value and from a large population, generally does not, by itself, provide sufficient evidence.

Consideration of Subsequent Events

6.48 The auditor's consideration of subsequent events in a compliance audit is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). The auditor should consider information about events relating to the applicable compliance requirements that comes to his or her attention after the end of the audit period and prior to the issuance of his or her report.

6.49 Two types of subsequent events require consideration by management and evaluation by the auditor. The first type consists of events that provide additional information about the entity's compliance during the audit period. For the period from the end of the audit period to the date of the auditor's report, the auditor should perform procedures to identify such events. These procedures should include, but may not be limited to, inquiries about and consideration of the following information:

- Relevant internal auditors' reports issued during the subsequent period

- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

6.50 The second type of subsequent events consists of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report. The auditor has no responsibility to detect such noncompliance. However, should such noncompliance come to the auditor's attention, it may be of such a nature and significance that the auditor should consider whether the matter is adequately disclosed in the notes to the schedule of expenditures of federal awards.

Evaluation and Reporting of Noncompliance

Instances of Noncompliance (Findings)

6.51 The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. Circular A-133 refers to these instances of noncompliance as "findings." Such findings may be of a monetary nature and involve questioned costs or may be nonmonetary and not result in questioned costs. Both *Government Auditing Standards* and Circular A-133 specify how certain findings should be reported. The auditor's opinion on compliance and his or her responsibilities for reporting findings are discussed in greater detail in chapter 10.

Compliance Opinion

6.52 Circular A-133 requires the auditor to report on compliance, which includes an opinion or disclaimer of opinion (on each major program) on whether the auditee complied with the applicable compliance requirements, and to prepare a schedule of findings and questioned costs (see paragraphs 10.41 through 10.46 and 10.55 through 10.67 for a further discussion). In evaluating whether the auditee complied with the compliance requirements in all material respects, the auditor should consider (*a*) the nature and frequency of the noncompliance identified, and (*b*) whether such noncompliance is material relative to the nature of the compliance requirements. Assessing materiality at the appropriate level is critical to the proper evaluation of findings. Materiality as it relates to giving an opinion on the auditee's compliance is discussed in paragraphs 6.13 through 6.16. The auditor's evaluation of the effect of questioned costs on the compliance opinion is discussed in paragraph 6.55.

Financial Statement Impact

6.53 The auditor also has the responsibility of assessing the impact of the actual and projected error noted in the single audit against the materiality level established for the basic financial statements (see paragraph 6.16). The auditor should consider the effect of (*a*) any contingent liability that may arise from the noncompliance in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and (*b*) for nongovernmental entities, any uncertainty regarding the resolution of instances of noncompliance in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

Questioned Costs

6.54 Questioned costs are defined by Circular A-133 to include costs that are questioned by the auditor because of an audit finding (*a*) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds, (*b*) for which the costs, at the time of the audit, are not supported by adequate documentation, or (*c*) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Evaluating the Effect of Questioned Costs on the Compliance Opinion

6.55 In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of the total costs questioned for each major program (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). There may be instances in which the known questioned costs are not considered material but the likely questioned costs are considered material. In this situation, the auditor should consider the noncompliance to be material or may expand the scope of the audit and apply additional audit procedures to further establish the likely questioned costs. For example, if an auditor's sample results in known questioned costs related to three sample items out of thirty selected, the three errors may not be considered material. However, the auditor's projection of those errors to the entire population may suggest that there are likely questioned costs that are material. In this example, the auditor should consider the noncompliance to be material and should report a finding or expand the scope of the audit and apply additional audit procedures.

Federal Agency Consideration of Findings and Questioned Costs

6.56 The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost, because the agency or entity has considerable discretion in these matters.

6.57 Circular A-133 defines a management decision as the evaluation by the federal awarding agency or pass-through entity of the audit findings and corrective action plan (see paragraphs 2.26 and 10.68 through 10.70 for a further discussion of the corrective action plan) and the issuance of a written decision as to what corrective action is necessary. Circular A-133 allows a federal awarding agency or pass-through entity receiving an auditor's report indicating findings and questioned costs six months after receipt of the audit report to issue such a decision. The nature of the questioned costs, as well as the amounts involved, are considered by the awarding agency or pass-through entity in issuing a management decision and deciding whether to disallow them. In addition, most federal awarding agencies have established appeal and adjudication procedures for questioned costs. Because of the discretion allowed in resolving these matters, all questioned costs are subject to uncertainty regarding their resolution.

Reporting the Findings

6.58 Circular A-133 requires the auditor to consider a different level of materiality for the purposes of reporting audit findings (see paragraphs 3.36

through 3.38 for a further discussion). Circular A-133 requires the auditor, in addition to providing an opinion on compliance, to include the following items, among other things, in the schedule of findings and questioned costs (see paragraph 10.56 for a complete listing of the items that are required to be included):

- Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement.*
- Known questioned costs that are greater than $10,000 for a type of compliance requirement for a major program (see paragraph 6.22 for a listing of the fourteen types of compliance requirements). Known questioned costs are those specifically identified by the auditor.
- Known questioned costs when likely questioned costs are greater than $10,000 for a type of compliance requirement.
- Known questioned costs that are greater than $10,000 for a federal program that is not audited as a major program (see paragraph 10.63 for a further discussion).

The reporting of findings is discussed in greater detail in paragraphs 10.63 and 10.64.

Reporting the Likely Questioned Costs

6.59 As noted before, in evaluating the effect of questioned costs on the opinion on compliance, the auditor considers both known questioned costs and the best estimate of the total costs questioned (likely questioned costs) for each major program. Known and likely questioned costs also need to be considered when audit findings are reported. In addition to reporting known questioned costs greater than $10,000 in the schedule of findings and questioned costs, the auditor is also required to report known questioned costs when likely questioned costs are greater than $10,000. For example, if the auditor specifically identifies $7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, the auditor estimates that the total questioned costs are in the $50,000–$60,000 range, the auditor would report a finding that indicates the known questioned costs of $7,000. See paragraph 10.63 for a further discussion.

Findings That Cannot Be Quantified

6.60 The auditor may discover instances of noncompliance that cannot be quantified. The auditor's responsibility for reporting such findings can best be described through an example. Assume that the auditor encounters a pass-through entity that consistently fails to provide its subrecipients with federal award information. Circular A-133 requires the auditor to consider all findings in relation to a type of compliance requirement (in the example provided, subrecipient monitoring is the relevant type of compliance requirement) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective included in the *Compliance Supplement* and relating to the example provided here is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance would be material in relation to the audit objective and, therefore, should be reported as an audit finding. In addition, the auditor should also consider whether reportable conditions exist and require reporting with respect to subrecipient monitoring.

Performing Follow-Up Procedures

Auditee Responsibilities for Audit Follow-Up and for the Summary Schedule of Prior Audit Findings

6.61 Circular A-133 states that the auditee is responsible for follow-up and corrective action on all audit findings. The follow-up required by Circular A-133 is facilitated by the requirement that the auditee prepare a summary schedule of prior audit findings (see paragraphs 2.21 and 10.68). This schedule reports the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It also includes audit findings reported in the prior audit's summary schedule of prior audit findings that were not identified as either (1) fully corrected, (2) no longer valid, or (3) not warranting further actions. Circular A-133 states that a valid reason for considering an audit finding as not warranting further action is that *all* of the following have occurred:

- Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse.
- The federal agency or pass-through entity is not currently following up with the auditee on the audit finding.
- A management decision was not issued.

6.62 Circular A-133 also states the following with regard to the auditee's schedule of prior audit findings:

- When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- When audit findings were not fully corrected or were only partially corrected, the summary schedule must describe the planned corrective action as well as any partial corrective action taken.
- When the corrective action taken is significantly different from the corrective action previously reported in a corrective action plan or in the federal agency's or pass-through entity's management decision, the summary schedule must provide an explanation.
- When the auditee believes the audit findings are no longer valid or do not warrant further actions, the reasons for this position must be described in the summary schedule (see paragraph 6.61).

Auditor Responsibilities for Follow-Up on Previously Reported Findings

6.63 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor should also perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year. The auditor's reporting responsibilities are further discussed in chapter 10.

Auditor Follow-Up Procedures

6.64 To follow up on previous audit findings, the auditor should obtain the auditee's summary schedule of prior audit findings and should review its contents with appropriate members of management. Although in many cases the procedures performed in the current audit will provide a basis for the auditor to assess the schedule, the auditor may find it necessary to perform procedures directed specifically at the status of prior audit findings. In these cases, the following procedures are to be considered:

- Inquiry of auditee management and program personnel
- Review of management decisions issued by federal awarding agencies or pass-through entities to the auditee (see paragraph 6.57)
- Observation of an activity that has been redesigned to address a prior-year finding
- Testing of similar current-year transactions

Audit Follow-Up for Findings Reported, as Required by Government Auditing Standards

6.65 As noted in paragraph 3.14, *Government Auditing Standards* establishes an additional fieldwork standard, which requires the auditor to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit to determine whether the auditee has taken timely and appropriate corrective actions. The auditee's schedule of prior audit findings is only required to include the status of prior-year findings relative to federal awards. However, there may be certain financial statement audit findings required to be reported under *Government Auditing Standards* that are included in the summary schedule of prior audit findings (because they also relate to federal awards). Also, although not required, some auditees may decide to include the status of other financial statement audit findings (that is, those that are not related to federal awards) in the schedule. For those financial statement audit findings included in the summary schedule of prior audit findings, the auditor's assessment of the reasonableness of the schedule (described in paragraphs 6.63 and 6.64) would meet the audit follow-up requirements of *Government Auditing Standards*. For financial statement audit findings that are not included in the schedule, the auditor should follow up on the findings to determine their status. See paragraph 10.62 for a discussion of the auditor's responsibility to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Corrective Action Plan

6.66 Circular A-133 also requires that upon completion of the audit, the auditee prepare a corrective action plan that identifies the contact person responsible for corrective action, indicates the corrective action planned, the anticipated completion date or, if the auditee does not agree with the finding, an explanation and specific reasons why the auditee disagrees. The auditor may find the auditee's corrective action plan useful in performing audit follow-up (in addition to the auditee's summary schedule of prior audit findings) because it may provide a preliminary indication of the corrective steps planned by the auditee.

Disputes or Unresolved Findings

6.67 There may be times when, as part of the follow-up on prior findings, the auditor determines that (*a*) a previous finding is the subject of a dispute between the auditee and the federal awarding agency or pass-through entity or (*b*) the federal awarding agency or pass-through entity has not addressed the finding by issuing a management decision. In these situations, if the finding relates to a current-year major program, the auditor should report similar transactions of the current year as findings and questioned costs until either the dispute is resolved or the initial finding no longer warrants further action under Circular A-133 as described in paragraph 6.61. However, if the auditor no longer believes that there is noncompliance because of additional evidence obtained in the current year, similar transactions need not be reported as findings.

Management Representations Related to Federal Awards

6.68 As part of an audit under Circular A-133, the auditor should obtain written representations from management about matters related to federal awards. Therefore, in addition to the management representations obtained in connection with an audit of the financial statements as discussed in paragraph 4.40, the auditor should obtain written representations from management concerning the identification and completeness of federal award programs, representations concerning compliance with compliance requirements, and identification of known instances of noncompliance.

Suggested Representations

6.69 The auditor should consider obtaining the following written representations in a single audit:[2]

- Management is responsible for complying, and has complied, with the requirements of Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with Circular A-133 and has included expenditures made during the period being audited for all awards provided by federal agencies in the form of grants, federal cost-reimbursement contracts, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance.
- Management is responsible for complying with the requirements of laws, regulations, and the provisions of contracts and grant agreements related to each of its federal programs.
- Management is responsible for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its federal programs.
- Management has identified and disclosed to the auditor the requirements of laws, regulations and the provisions of contracts and grant agreements that are considered to have a direct and material effect on each federal program.

[2] These representations may be added to a representation letter obtained in connection with an audit of the financial statements instead of a separate letter.

- Management has made available all contracts and grant agreements (including amendments, if any) and any other correspondence that have taken place with federal agencies or pass-through entities and are related to federal programs.
- Management has complied, in all material respects, with the compliance requirements in connection with federal awards except as disclosed to the auditor.
- Management has identified and disclosed to the auditor all amounts questioned and any known noncompliance with the requirements of federal awards, including the results of other audits or program reviews.
- Management's interpretations of any compliance requirements that have varying interpretations have been provided.
- Management has made available all documentation related to the compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Federal program financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared, and are prepared on a basis consistent with that presented in the schedule of expenditures of federal awards.
- The copies of federal program financial reports provided to the auditor are true copies of the reports submitted, or electronically transmitted, to the federal agency or pass-through entity, as applicable.
- If applicable, management has monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and has met the requirements of Circular A-133.
- If applicable, management has issued management decisions on a timely basis after their receipt of subrecipients' auditor's reports that identified noncompliance with laws, regulations, or the provisions of contracts or grant agreements, and has ensured that subrecipients have taken the appropriate and timely corrective action on findings.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to their own books and records.
- Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by Circular A-133.
- Management has provided the auditor with all information on the status of the follow-up on prior audit findings by federal awarding agencies and pass-through entities, including all management decisions.
- Management has accurately completed the appropriate sections of the data collection form.
- If applicable, management has disclosed all contracts or other agreements with the service organizations.
- If applicable, management has disclosed to the auditor all communications from the service organization relating to noncompliance at the service organization.

- Management has disclosed any known noncompliance occurring subsequent to the period for which compliance is audited.
- Management has disclosed whether any changes in internal control over compliance or other factors that might significantly affect internal control, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred subsequent to the date as of which compliance is audited.

Refusal to Furnish Written Representation

6.70 Management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the auditee's compliance with major program requirements. The auditor should also consider the effects of management's refusal on his or her ability to rely on other management representations.

State and Local Government Compliance Auditing Considerations

6.71 An auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to the testing and reporting requirements imposed by *Government Auditing Standards* and Circular A-133. Although such auditing is outside the scope of this SOP, such a requirement may specify compliance tests, similar to those in a single audit. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of the required testing. However, state or local government funds should be distinguished from pass-through federal funds. When a single audit is conducted, pass-through federal funds are considered part of the federal awards received. See paragraphs 3.47 through 3.49 for a brief discussion of state and local compliance requirements.

Chapter 7

DETERMINATION OF MAJOR PROGRAMS

7.1 As noted in paragraph 2.22, Circular A-133 requires the auditee to identify in its accounts all federal awards received and expended and the federal programs under which they were received. The auditee is also required to prepare a schedule of expenditures of federal awards for the period covered by its financial statements (see chapter 5 for a further discussion of the requirements related to this schedule). However, Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides the criteria to be used in applying a risk-based approach to determining major programs. The risk-based approach is designed to focus the single audit on higher-risk programs. See paragraph 7.20 for a description of when the auditor can deviate from the use of risk criteria.

7.2 The auditor's determination of the programs to be audited is based on an evaluation of the risk of noncompliance occurring that could be material to an individual major federal program. In evaluating such risk, the auditor considers, among other things, the current and prior audit experience with the auditee, the oversight exercised by federal agencies and pass-through entities, and the inherent risk of the federal programs. The auditor should use professional judgment and the guidance in sections 520, 525, and 530 of Circular A-133 in the risk assessment process. In addition, the auditor should consider the need to discuss the nature of federal programs with the management of the auditee and of the federal or state agency that provided the funds to the auditee.

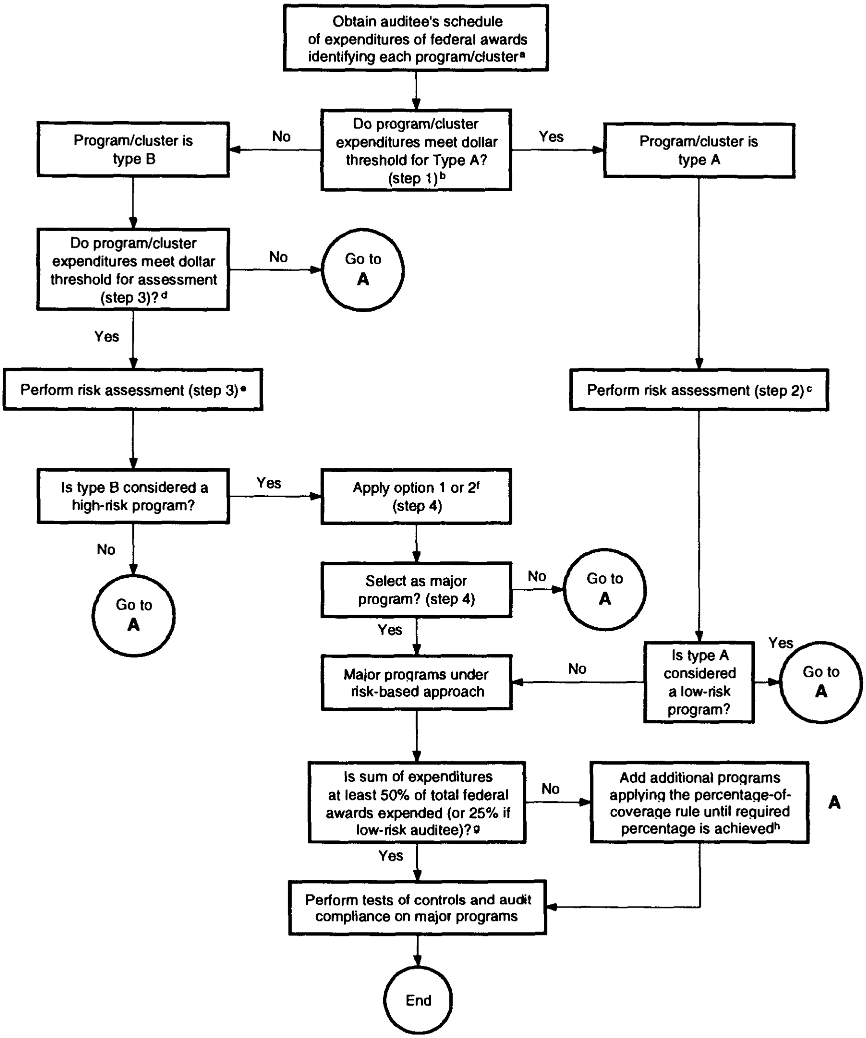
Applying the Risk-Based Approach

7.3 The guidance on the risk-based approach is organized here as provided in Circular A-133 and consists of the following steps (see table 7.1 for a flowchart illustration of applying the risk-based approach for determining major programs):

- Step 1—determination of type A and type B programs (paragraphs 7.4 through 7.9)
- Step 2—identification of low-risk type A programs (paragraphs 7.10 through 7.13)
- Step 3—identification of high-risk type B programs (paragraphs 7.14 through 7.16)
- Step 4—determination of programs to be audited as major (paragraphs 7.17 through 7.20)

Exhibit 7.1

Flowchart Illustration of Applying the Risk-Based Approach for Determining Major Programs



a. See paragraph 1.18 for the definition of federal programs, including clusters.

b. See paragraphs 7.4 through 7.9 for a detailed discussion of step 1.

c. See paragraphs 7.10 through 7.13 for a detailed discussion of step 2.

d. See paragraphs 7.14 through 7.16 for a detailed discussion of step 3.

e. Before performing the risk assessment, the auditor should consider whether option 1 or option 2 will be selected under step 4 because it will affect whether risk assessments need to be performed on all type B programs or only some type B programs. See paragraph 7.15.

f. The number of type B high-risk programs identified as major programs is either—

- *Option 1*: one-half of the number of type B high-risk programs, unless this number exceeds the number of low-risk type A programs identified in step 2. In this case, the auditor would be required to audit as major the same number of high-risk type B programs as low-risk type A programs. Under this option, the auditor is expected to perform risk assessments on all type B programs that exceed the threshold for type B.

- *Option 2*: one high-risk program for each low-risk type A program. This option does not require the auditor to perform risk assessments on all type B programs. See paragraphs 7.17 through 7.20 for a detailed discussion of step 4, including option 1 and option 2.

g. There may be instances when the auditee includes certain noncash assistance (such as loan guarantees or loans) in the notes to the schedule of expenditures of federal awards (see paragraph 5.13). The auditor should be sure to include such noncash assistance as part of total federal awards expended when performing this calculation.

h. The additional programs/clusters selected (marked "A" on the flowchart) to meet the percentage-of-coverage rule are audited as major programs in addition to type A and type B programs identified in steps 1 through 4. See paragraph 7.24 for a further discussion of the percentage-of-coverage rule.

Step 1—Determination of Type A and Type B Programs

7.4 To determine which federal programs are to be audited as major (see step 4), the auditor must first identify federal programs as being either type A or type B as defined in Circular A-133. In general, type A programs are larger federal programs and type B programs are smaller federal programs. The auditor should obtain the schedule of expenditures of federal awards from the auditee to assist in the identification of type A and type B programs. The schedule of expenditures of federal awards, prepared by the auditee, includes all cash and noncash awards either on the face of the schedule or in the notes to the schedule. Auditors should note that for purposes of determining major programs, a cluster of programs should be considered as one program (see paragraphs 1.18, 1.19, 2.18, 5.6, and 8.30 for a further discussion of a cluster of programs).

Type A Program Criteria

7.5 The larger federal programs are labeled as type A. The criteria that Circular A-133 establishes for identifying Type A programs are presented in table 7.1.

Table 7.1

Criteria for Identifying Type A Programs

When Total Federal Awards Expended Are—*	*A Type A Program Is Any Program With Federal Awards Expended That Exceed the Larger of—*
More than or equal to $300,000 and less than or equal to, $100 million	$300,000 or 3% (0.03) of federal awards expended
More than $100 million and less than or equal to $10 billion	$3 million or 0.3% (0.003) of federal awards expended
More than $10 billion	$30 million or 0.15% (0.0015) of federal awards expended

* Includes both cash and noncash awards.

Type B Program Criteria

7.6 Federal programs that do not meet the type A criteria are considered type B programs.

Effect of Large Loans and Loan Guarantees on Identification of Type A Programs

7.7 The various types of noncash awards, including loans and loan guarantees, and how they are valued are discussed in chapter 5. Circular A-133 states that when the auditor applies the dollar criteria shown in table 7.1 to identify type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. Auditors should note that this requirement relates only to loans and loan guarantees and not to any other large noncash awards. When a federal program providing loans or loan guarantees *significantly affects* the number or size of type A programs, the auditor should consider the loan or loan guarantee program a type A program and exclude its values in determining other type A programs. The auditor should use professional judgment in determining whether type A programs would be *significantly* affected in this situation.

7.8 The example in table 7.2 demonstrates this concept by showing the identification of type A programs as well as the effect of loans and loan guarantees on that identification process.

Table 7.2

Identification of Type A Programs and the Effect of Loans and Loan Guarantees

Program / Federal Grantor	*Federal Awards Expended ($000)*
Cash program A—U.S. Department of Labor	$ 1,335
Cash program B—U.S. Department of Health and Human Services	3,000
Cash program C-1—U.S. Department of Education	175
Cash program C-2—U.S. Department of Education	280
Cash program D—U.S. Department of Housing and Urban Development (a pass-through grant from a local government)	310
Subtotal—cash federal awards expended	$ 5,100
Commodities program E—U.S. Department of Agriculture (a pass-through grant from a state)	2,000
Subtotal—cash and commodities federal awards expended	$ 7,100
Loan program F—U.S. Department of Housing and Urban Development	33,500*
Loan guarantee program G—U.S. Department of Agriculture	57,000*
Total federal awards expended	$97,600

* In accordance with Circular A-133, loans and loan guarantees include new loans made during the year, plus prior-year loans for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received. See paragraphs 5.14 and 5.15 for additional information.

7.9 In table 7.2 the auditee has $97,600,000 in total federal awards expended. Therefore, an application of the criteria in table 7.1 would indicate that type A programs would be those that expended federal awards equal to or greater than $2,928,000 (3 percent of $97,600,000), or programs B, F, and G. However, when large loan and loan guarantee programs F and G are excluded from the base amount of the total federal awards expended in the calculation, the type A programs would be those programs that expended federal awards equal to or greater than $300,000 (the larger of $213,000 [3 percent of $7,100,000], or $300,000). Therefore, under the second calculation programs A, B, D, E, F, and G would be type A programs. If the auditor, in his or her professional judgment, concludes that the difference in the number or size of type A programs is significantly affected by the inclusion of the loans and loan guarantees (which in this example would be likely due to the significant increase in type A programs), the auditor would identify programs A, B, D, E, F, and G as type A programs. The auditor should consider contacting the cognizant or oversight agency for audit if the auditor is unsure about whether to exclude loan or loan guarantees when determining type A programs.

Step 2—Identification of Low-Risk Type A Programs

7.10 After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low-risk. Circular A-133 includes certain conditions that, when met, indicate that a type A program may be low-risk.

General Conditions for Low-Risk Type A Programs

7.11 Type A programs may generally be considered low-risk if both of the following conditions are met: (*a*) the program has been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and (*b*) in the most recent audit period, the *program* had no audit findings (see paragraph 10.63 for a description of audit findings).

Auditor Judgment in Determination of Low-Risk Type A Programs

7.12 Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though (*a*) in the prior audit period it may have had known or likely questioned costs greater than $10,000 for a type of compliance requirement, (*b*) known fraud has been identified, or (*c*) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. For example, consider a situation in which the funds expended under a federal program in the prior year totaled $10 million, there were known questioned costs of $11,000 that related to one isolated instance, and there were no additional likely questioned costs. In this example, the auditor, based on professional judgment, could decide that the program is low-risk in the current year. In making the final determination of whether a type A program is low-risk, the auditor should also consider the risk criteria in paragraphs 7.26 through 7.36, the results of audit follow-up, and whether any changes in the personnel or systems affecting a type A program have significantly increased its risk. Based on all of this information, the auditor would apply professional judgment in determining whether a type A program is low-risk.

Type A Program Not Considered Low-Risk at Request of Federal Awarding Agency

7.13 A federal awarding agency may request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. For example, it may be necessary for a large type A program to be audited as major each year for particular recipients, to allow the federal agency to comply with the Government Management Reform Act of 1994. In this instance, Circular A-133 requires the federal awarding agency to obtain approval from the OMB. Furthermore, the federal awarding agency must notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year end to be audited. (See also paragraph 7.35 for a discussion of the federal agency or pass-through entity option to identify federal programs as higher risk in the *Compliance Supplement*.)

Step 3—Identification of High-Risk Type B Programs

7.14 After completing steps 1 and 2, the auditor should identify type B programs that are high-risk, using professional judgment and the risk criteria discussed in paragraphs 7.26 through 7.36. Except for known reportable conditions in internal control or instances of noncompliance, a single risk criteria would, in general, seldom cause a type B program to be considered high-risk.

7.15 Before beginning step 3, the auditor should—

a. Consider whether there are low-risk type A programs. When there are no type A programs identified as low-risk (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. Instead, the auditor would audit as major enough type B programs to meet the percentage-of-coverage rule (see paragraph 7.24). When there are type A programs, but none are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule. In either case, any programs requested to be audited by a federal agency or pass-through entity must be audited as a major program and would be included in determining whether the percentage-of-coverage rule has been met (see paragraph 7.21).

b. Consider whether option 1 or option 2 will be used in step 4 (see paragraphs 7.18 through 7.19 for a detailed description of each option). The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. The auditor should consider the following discussion before deciding whether to use option 1 or option 2.

- Under option 1, the auditor is required to perform a risk assessment on all type B programs (excluding small type B programs as discussed in paragraph 7.16). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Also assume that the auditor chooses option 1. In this scenario, the auditor would be required to perform a risk assessment on all type B programs. If the auditor finds that only four type B programs are high-risk, the auditor would only be required to audit two of the four high-risk type B programs as major (one-half of the number of high-risk type B programs).
- Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Assume also that the first four type B programs subject to risk assessment are determined by the auditor to be high-risk. In this scenario, the auditor may choose option 2, identify the four high-risk type B programs as major, and not perform risk assessments on the remaining six type B programs. Using the same example but assuming that the auditee only has one low-risk type A program (instead of four), the auditor would be required to audit one type B program as major under either option 1 or 2. In this scenario, option 2 would likely be the most efficient choice for the auditor since the auditor would only need to perform type B program risk assessments until one high-risk type B program was identified (under option 1 the auditor would be required to perform a risk assessment on all type B programs.

Criteria for Performing Risk Assessments on Type B Programs

7.16 An auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, Circular A-133 only requires the auditor to perform risk assessments on type B programs that exceed the larger of the criteria shown in table 7.3.

Table 7.3

Criteria for Performing Risk Assessments on Type B Programs

When Total Federal Awards Expended Are—*	*Perform Risk Assessment for Type B Programs That Exceed the Larger of—*
More than or equal to $300,000 and less than or equal to $100 million	$100,000 or 0.3% (0.003) of federal awards expended
More than $100 million	$300,000 or 0.03% (0.0003) of federal awards expended

* Includes both cash and noncash awards.

Step 4—Determination of Programs to Be Audited as Major

Criteria for Major Programs

7.17 After completing steps 1 through 3, the auditor identifies the major programs. At a minimum, Circular A-133 requires the auditor to audit all of the following as major programs:

- All type A programs, except those identified as low-risk under step 2 (see paragraphs 7.10 through 7.13)
- High-risk type B programs as identified under either of the two options described in paragraph 7.18
- Programs to be audited as major based on a federal agency request (in lieu of the federal agency conducting or arranging for additional audits; see paragraph 7.21 for further information)
- Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described in paragraph 7.24

Two Options Available for Identifying High-Risk Type B Programs

7.18 Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs:

- *Option 1.* Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in table 7.3, and to audit at least one-half of the high-risk type B programs as major, unless this number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap. For example, consider an auditee that has ten low-risk type A programs, and fifty type B programs above the amount specified in table 7.3. Under this option, the auditor would be required to perform risk assessments of the fifty type B programs. Assume that based on that assessment, the auditor determines that there are twenty-five high-risk type B programs. One-half of the twenty-five high-risk type B programs is 12.5, which rounds up to thirteen programs. Under this option, the auditor would audit thirteen of the high-risk type B programs as major; however, since the cap in this example is ten (that is, the number of low-risk type A programs), the auditor is only required to audit ten high-risk type B programs as major.

- *Option 2.* Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero). Continuing with the previous example, under option 2 the auditor would perform risk assessments of type B programs until ten high-risk programs are identified (that is, ten is the number of low-risk type A programs). The auditor would then audit as major the ten type B programs identified as high-risk. Depending on the order in which risk assessments on type B programs are performed, the auditor might only need to perform risk assessments of ten type B programs determined to be high-risk, or the auditor may need to perform risk assessments on additional Type B programs until ten high-risk programs are identified.

7.19 The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs (see paragraph 7.15). Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Deviation From Use of Risk Criteria

7.20 For first-year audits, Circular A-133 allows auditors to deviate from the above-described risk assessment process. A first-year audit is defined as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. This exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in paragraph 7.24. Under this option, the auditor is not required to perform steps 2, 3, and 4. However, to ensure that a frequent change of auditors would not preclude the audit of high-risk type B programs, this election for first-year audits may not be used more than once every three years. Auditors should consider whether this exception is an option during the planning phase of the single audit (see also paragraphs 3.28 and 3.29 for a discussion of initial-year audit considerations).

Other Considerations Regarding the Risk-Based Approach

Federal Agency Requests for Additional Major Programs

7.21 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not, informing the agency of the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Documentation of Risk Assessment in the Working Papers

7.22 Circular A-133 requires the auditor to document in the working papers the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by GAAS and *Government Auditing Standards,* the determination of major programs (see the discussion of working paper requirements in paragraphs 3.16 through 3.18 and 3.22 through 3.23).

Auditor Judgment in the Risk Assessment Process

7.23 Circular A-133 states that when the determination of major programs is performed and documented by the auditor in accordance with the circular, the auditor's judgment in applying the risk-based approach to determine major programs is presumed correct. Challenges by federal agencies and pass-through entities should only be made for clearly improper use of the guidance in Circular A-133. It should be noted, however, that federal agencies and pass-through entities may provide the auditor with guidance about the risk of a particular federal program, which the auditor should consider when determining major programs.

Percentage-of-Coverage Rule

7.24 Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended. However, if the auditee meets the criteria for a low-risk auditee (see paragraph 7.25), the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. To comply with this requirement, the auditor should compute the total federal awards expended for the major programs, determined under step 4, as a percentage of the total federal awards expended. If the total does not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal 50 percent (or 25 percent in the case of a low-risk auditee) and test them as major programs. The selection of additional programs to meet the percentage of coverage is based on the auditor's professional judgment. When selecting additional programs to meet the percentage-of-coverage rule, the auditor may select programs without regard to risk assessment. If loans or loan guarantees are major programs, these programs may be used for purposes of meeting the percentage-of-coverage rule. Furthermore, when a federal agency or pass-through entity requests and pays for a program to be audited as major (see paragraph 7.21), that program may also be used for purposes of meeting the percentage-of-coverage rule.

Low-Risk Auditee Criteria

7.25 Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following conditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for the reduced audit coverage discussed in paragraph 7.24:

a. Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.

b. The auditor's opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.

c. There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.

d. None of the federal programs had audit findings from any of the following in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) in which they were classified as type A programs:
   - Material weaknesses in the internal control over compliance
   - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program
   - Known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year

Criteria for Federal Program Risk

7.26 The auditor's risk assessment should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the federal program being evaluated. Circular A-133 indicates that the auditor should use professional judgment and consider certain criteria to identify risk in federal programs. As a part of the risk assessment, the auditor may also wish to discuss a particular federal program with auditee management and with the federal agency or pass-through entity. The criteria for federal program risk that are identified in Circular A-133 are discussed in the following sections.

Current and Prior Audit Experience

7.27 The auditor should consider his or her prior experience with the auditee and the results of audits performed in the past. The following specific factors that should be considered:

- Weaknesses in the internal control over compliance for federal programs (paragraph 7.28)
- Federal programs administered under multiple internal control structures (paragraph 7.29)

- A weak system for monitoring subrecipients when significant parts of federal programs are passed through to subrecipients (paragraph 7.30)
- The extent to which computer processing is used (paragraph 7.31)
- Prior audit findings (paragraph 7.32)
- Federal programs not recently audited as major (paragraph 7.33)

Weaknesses in Internal Control Over Federal Programs

7.28 In assessing program risk, the auditor should consider internal control over compliance for federal programs (see chapter 8 for detailed guidance on internal control over compliance for federal programs). Weak internal control over compliance for federal programs is an indication of higher risk. Consideration should also be given to the control environment over federal programs and to such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements. The auditor may also consider the competence and experience of the personnel who administer federal programs. In instances in which the staff are new or do not have experience with a program, consideration should be given to assessing the program at a higher level of risk.

Federal Programs Administered Under Multiple Internal Control Structures

7.29 Federal programs administered by multiple internal control structures may have a higher risk. This often occurs when multiple operating units are involved in the administration of federal programs. An example of this would be a university that has several campuses administering a federal program. When assessing risk, the auditor should consider whether any internal control weaknesses are isolated in a single operating unit (that is, one college campus) or are pervasive throughout the entity. If the identified weaknesses are isolated, and absent other weaknesses, the auditor could still potentially reach the conclusion that the program is low-risk. The final determination would be based on the auditor's judgment.

Weak System for Monitoring Subrecipients

7.30 Consideration should be given to the extent that federal programs are passed through to subrecipients. If the auditee passes a significant portion of a federal program to subrecipients and the auditor has identified that the auditee has a weak system for monitoring subrecipients, the auditor should consider assigning a higher risk to the program. Alternatively, if the auditee passes a significant portion of programs to subrecipients and the auditee has an effective system in place to monitor the subrecipients, the auditor should consider assigning a lower level of risk to the program.

Extent to Which Computer Processing Is Used

7.31 When assessing risk, the auditor should consider the extent to which computer processing is used to administer federal programs, as well as the complexity of that processing. A complex system does not always indicate higher risk. On the other hand, a newly installed system that has not been tested in the past, or a recently modified system, may indicate higher risk. Auditors should refer to SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to SAS No. 31,* Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec.

326), for guidance when significant auditee information is transmitted, processed, maintained, or accessed electronically.

Prior Audit Findings

7.32 As a part of the risk assessment, the auditor should consider prior audit findings. These findings may be the result of previous single audits by independent auditors or of compliance or financial audits performed by internal auditors or government auditors in conjunction with the federal awarding agency's monitoring activities. The auditor should consider assessing a higher risk for programs for which prior audit findings have a significant impact on a federal program or for which no corrective action has been implemented since the findings were identified.

Federal Programs Not Recently Audited as Major

7.33 Federal programs that have not recently been audited as major programs may be of higher risk than federal programs recently audited as major. For example, many type B programs may never have been audited as major programs in the past. A higher level of risk would likely be assessed on such programs than on those programs that have been consistently audited as major programs without audit findings.

Oversight Exercised by Federal Agencies and Pass-Through Entities

7.34 The oversight exercised by federal agencies or pass-through entities could indicate risk. An important factor in assessing risk is the results of recent audits performed by federal agencies or pass-through entities. For example, recent monitoring or other reviews that were performed by an oversight entity and that disclosed no audit findings may indicate lower risk, whereas monitoring that disclosed significant findings could indicate higher risk. However, the auditor should understand the scope of the review that was performed. Reviews performed by federal agencies or pass-through entities vary widely as to coverage and intensity.

7.35 Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are high-risk. This identification will be provided by the OMB in the *Compliance Supplement*. For example, the U.S. Department of Health and Human Services has identified the Medicaid Assistance Program as a program of higher risk in the *Compliance Supplement*. Although such an identification by a federal agency does not preclude an auditor from determining that a program is low-risk (for example, because prior audits have shown strong internal control and compliance), the auditor should consider it as part of the risk assessment process.

Inherent Risk of the Federal Programs

7.36 As part of the risk assessment, the auditor needs to consider the inherent risk of federal programs. Inherent risk is the risk that material noncompliance with requirements applicable to a major program could occur, assuming there is no related internal control. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides examples of program characteristics with potentially higher inherent risks; these are discussed in paragraphs 6.8 and 6.9.

Chapter 8

CONSIDERATION OF INTERNAL CONTROL OVER COMPLIANCE FOR MAJOR PROGRAMS

8.1 Circular A-133 establishes requirements for additional audit procedures and reporting relative to the auditor's consideration of internal control over compliance for major programs. These requirements are beyond those of a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*. The auditor's consideration of internal control over financial reporting is discussed in chapter 4. In this chapter, the additional considerations of internal control over compliance for major programs are discussed. The reporting on internal control over compliance for major programs is discussed in paragraph 8.3 and chapter 10.

Summary of Circular A-133 Requirements Related to Internal Control Over Compliance for Federal Programs

Auditee Responsibilities

8.2 Circular A-133 requires the auditee to maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs.

Auditor Responsibilities

8.3 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to—

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform testing of the internal control over compliance as planned.
- Report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, where applicable, referring to the separate schedule of findings and questioned costs. This schedule includes, where applicable, a statement that reportable conditions in internal control over compliance for major programs were disclosed by the audit and whether any such conditions were material weaknesses.

Auditor Responsibility for Internal Control Over Compliance for Programs That Are Not Major

8.4 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs (see chapter 7). However, the auditor should note that a program that is not considered major could still be material to the financial statements. In this situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of the internal control over financial reporting that is relative to the program. The auditor's consideration of internal control over financial reporting is discussed in chapter 4.

Circular A-133 Definition of Internal Control Over Federal Programs

8.5 Circular A-133 defines internal control over federal programs as follows.

> Internal control pertaining to the compliance requirements for federal programs (*Internal control over federal programs*) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:
>
> 1. Transactions are properly recorded and accounted for to:
>   *a.* Permit the preparation of reliable financial statements and federal reports;
>   *b.* Maintain accountability over assets; and
>   *c.* Demonstrate compliance with laws, regulations, and other compliance requirements;
> 2. Transactions are executed in compliance with:
>   *a.* Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
>   *b.* Any other laws and regulations that are identified in the compliance supplement; and
> 3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Control Objectives

8.6 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, states that there are three categories of internal control: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. For purposes of this SOP, controls relevant to the audit of the financial statements are referred to as "internal control over financial reporting" and are encompassed in the report on internal control over financial reporting that is required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP "as internal control over compliance" and are encompassed in the report on internal control over compliance required by Circular A-133 (see paragraphs 10.46 through 10.49). See paragraphs 4.11 and 4.12 for a more detailed discussion.

Auditor's Consideration of Internal Control Over Compliance for Each Major Program

8.7 The auditor's consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting in a financial statement audit as described in SAS No. 55, as amended by SAS No. 78. In his or her consideration of internal control over compliance, the auditor—

- Obtains an understanding of internal control over compliance for federal programs that is sufficient to plan the audit, by performing procedures to understand (*a*) the design of controls relevant to the compliance requirements for each major program and (*b*) whether they have been placed in operation (note that although Circular A-133 requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, it does not actually require the achievement of a low assessed level of control risk).
- Assesses control risk for the assertions relevant to the compliance requirements for each major program. The auditor uses the knowledge provided by the understanding of internal control over compliance and the assessed level of control risk to determine the nature, timing, and extent of substantive tests for assertions relevant to the compliance requirements for each major program. Compliance auditing is discussed in chapter 6.

8.8 An understanding of the internal control over compliance and an assessment of control risk may be performed concurrently in an audit. Similarly, based on the assessed level of control risk that the auditor expects to support and on audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining an understanding of controls.

Obtaining an Understanding of Internal Control Over Compliance for Major Programs

Understanding Compliance Assertions and Identifying Relevant Controls

8.9 As noted in paragraph 8.3, the auditor is required to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs. The determination of major programs is discussed in chapter 7. The auditor needs to understand the assertions relevant to the compliance requirements for each major program. Those assertions will determine the types of controls the auditor needs to consider in a single audit. In identifying controls relevant to specific assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion depending on the nature of the particular internal control component involved. An entity generally also has controls relating to objectives that are not relevant to specific assertions and that therefore need not be considered in a Circular A-133 audit.

8.10 In obtaining an understanding of controls, the auditor should consider the guidance in paragraphs 41 through 43 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.41–.43). This includes performing procedures to provide sufficient knowledge of both the design of the relevant controls pertaining to each of the five internal control components (that is, control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor ordinarily obtains this knowledge through previous experience with the entity and through such procedures as inquiries of appropriate management, supervisory, and staff personnel; an inspection of the entity's documents and records; and his or her observation of the entity's activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

8.11 Entities may use the same controls for more than one federal program and for similar transactions (for example, cash disbursements). Accordingly, those controls will often provide assurance regarding the achievement of the compliance objectives related to some or all federal program transactions and assets.

OMB Compliance Supplement *Internal Control Guidance*

8.12 When determining the assertions relevant to the compliance requirements for each major program of the entity, the auditor should consider referring to the discussion on internal control found in part 6 of the *Compliance Supplement*. The *Compliance Supplement* provides a general discussion of the control objectives, components, and activities that are likely to apply to the fourteen types of compliance requirements (see the discussion of the types of compliance requirements in paragraph 6.22). This guidance is not a checklist of required internal control characteristics; it is intended, instead, to assist the auditor in planning and performing the single audit. However, the auditee is responsible for designing and implementing internal control that is sufficient to provide reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Control activities beyond those discussed in the *Compliance Supplement* may need to be designed and implemented by the auditee to meet this responsibility. Similarly, the auditor is responsible for evaluating internal control over compliance, to plan the audit to support a low assessed level of control risk for each major program. The auditor may need to perform tests of internal control over compliance that are related to control objectives and activities in addition to those discussed in the *Compliance Supplement.*

Multiple-Component Considerations

8.13 Federal programs are often administered by several organizational components within an auditee. Each component may maintain separate internal control over compliance that is relevant to the programs, or parts of the programs, that the component administers. In these situations, the auditor should perform procedures to obtain an understanding of the internal control over compliance that is separately maintained by organizational components and that is relevant to each material part of a major program, and should plan and perform testing of those controls as discussed in this chapter (see also paragraphs 6.34 and 7.29 for other multiple-component considerations).

Subrecipient Considerations

8.14 Many entities that are pass-through entities for federal awards make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The auditor of the pass-through entity has certain considerations related to the entity's internal control over the monitoring of subrecipients. See paragraph 9.23 for a discussion of the audit considerations of federal pass-through awards.

Planning and Performing Testing of Internal Control Over Compliance for Major Programs

Assessing Control Risk

8.15 After obtaining an understanding of internal control over compliance for major programs, the auditor makes a preliminary assessment of control risk for the assertions relevant to the compliance requirements for each major program (see also the related discussion in paragraphs 6.7 through 6.12). Control risk is the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the auditee's internal control over compliance. The assessment of control risk is the process of evaluating the effectiveness of an entity's internal control over compliance in preventing or detecting material noncompliance with the compliance requirements for each major program. In assessing control risk, the auditor should consider the guidance in paragraphs 45 through 57 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.45–.57). The auditor should consider the preliminary assessment of control risk when he or she designs the nature and extent of tests of compliance. The Circular A-133 requirement to plan the testing of internal control over compliance to support a low assessed level of control risk is discussed in paragraphs 8.16 through 8.19. The auditor's responsibilities when the internal control over compliance is ineffective in preventing or detecting noncompliance are discussed in paragraphs 8.20 through 8.22.

Planning the Testing of Internal Control Over Compliance for Major Programs to Support a Low Assessed Level of Control Risk

8.16 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk. A low assessed level of control risk can only be understood in relative terms when it is compared with maximum or moderate levels. Therefore, the auditor exercises professional judgment to determine the procedures necessary to obtain a low level of control risk. The auditor should consider the purpose of the requirement to plan the tests of controls to achieve a low assessed level of control risk (that is, federal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations).

8.17 Assessing control risk at below the maximum level involves (*a*) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and (*b*) performing tests of controls to evaluate the effectiveness of such controls.

8.18 When the auditor assesses control risk at below the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads all bear on the degree of assurance the evidential matter provides. In obtaining evidential matter, the auditor should consider the guidance in paragraphs 64 through 78 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.64–.78).

8.19 Paragraph 4.32 of *Government Auditing Standards* provides the following additional guidance related to the assessment of control risk:

- The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.
- Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
- Inquiries alone generally will not support an assessment that control risk is below the maximum.
- Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.
- Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.

Existence of Ineffective Internal Control in Preventing or Detecting Noncompliance

8.20 When internal control over compliance for some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan and perform tests of internal control over compliance as described in paragraphs 8.3, 8.16, and 8.23. If the internal control over compliance is deemed likely to be ineffective, Circular A-133 requires the auditor to assess control risk at the maximum and consider whether any additional compliance tests are required because of ineffective internal control. The auditor is also required to report a reportable condition (including whether such condition is a material weakness) as part of the audit findings (see paragraphs 10.46, 10.56, and 10.63 for a discussion of how reportable conditions should be reported).

8.21 The assessment of the effectiveness of internal control over compliance in preventing or detecting noncompliance is determined in relation to each individual type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. For example, controls over requirements for eligibility may be ineffective because of a lack of segregation of duties. In this case, the auditor would be required to—

- Report the lack of segregation of incompatible duties as it relates to eligibility as a reportable condition (note that the reportable condition could be a material weakness).
- Assess the control risk related to requirements for eligibility at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures designed to test compliance with requirements for eligibility of the major program. In most cases, the extent of testing would need to be expanded.

8.22 In planning the tests of controls, the auditor will need to consider the results of tests performed in prior years. If the results of the prior year tests of controls prevented a low level of control risk assessment, the auditor may consider expanded testing in the next audit period. That consideration should include the testing of any changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year. If, however, the auditee has made no changes to its internal control over compliance, the auditor may determine that controls are not likely to be effective and may choose not to plan and perform tests of controls. In this situation, a reportable condition should be reported (see paragraph 8.20).

Performing Tests to Evaluate the Effectiveness of Controls

8.23 As noted in paragraph 8.3, Circular A-133 requires the auditor to perform testing of internal control over compliance as planned (see paragraphs 8.20 through 8.22 for an exception related to ineffective internal control over compliance). Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.52 and 319.53). Tests of controls, which are directed toward either the effectiveness of the design or the operation of a control, may include such steps as (*a*) inquiries of appropriate personnel, including grant and contract managers; (*b*) the inspection of documents and reports; (*c*) the observation of the application of the specific controls; and (*d*) the reperformance of the application of the controls by the auditor. The auditor should perform such procedures (unless control is likely to be ineffective) regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

Evaluating the Results of Tests of Controls

8.24 If, when evaluating the results of tests of controls, the auditor is not able to support a low assessed level of control risk for major programs, the auditor is not required to expand his or her testing of internal control over compliance. The auditor may choose not to perform further tests. In this situation, the auditor would assess control risk at other than low, design tests of compliance accordingly, and consider the need to report an audit finding (see paragraph 10.63). In general, a reportable condition or a material weakness will need to be reported. Similarly, the auditor may decide to expand the testing of internal control over compliance, but that decision would be based on whether the auditor considered expanded internal control testing to be more efficient than additional tests of compliance. The auditor should consider whether, based on the testing performed, control risk can be assessed at below the maximum to reduce substantive tests of compliance. If it cannot, the auditor should assess control risk at the maximum level.

Reportable Conditions and Material Weaknesses Related to Federal Programs

8.25 For purposes of reporting on internal control over compliance for federal programs, the definitions of a reportable condition and a material weakness, which are similar to those in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, are as follows:

- A *reportable condition* is a matter coming to the auditor's attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in the auditor's judgment, could adversely affect an entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.
- A *material weakness* in internal control over compliance is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

8.26 In performing a single audit, the auditor should be aware that reportable conditions and material weaknesses are to be considered as they relate to a type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. Furthermore, certain conditions may be reportable conditions for a major program and not be considered reportable conditions as they relate to the assertions of management in the financial statements.

Documentation Requirements

8.27 The auditor should document his or her understanding of the auditee's internal control components that was obtained to plan the audit, and should document the basis for his or her conclusions about the assessed level of control risk related to the internal control over compliance for major programs. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraphs 8.20 through 8.22, then the rationale for omitting such tests should be documented.

8.28 As noted in paragraphs 3.16 through 3.18, *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

8.29 The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as the nature of the auditee's internal control over compliance. For example, the documentation of the understanding of internal control over compliance of a large, complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, the documentation may be less extensive. In general, the more complex the internal control over compliance and the more extensive the procedures performed, the more extensive the auditor's documentation.

Program Cluster Considerations

8.30 An entity may have separate controls related to individual federal programs that are treated as one program "cluster" under a Circular A-133 audit (for example, SFA and R&D—see paragraphs 1.18, 1.19, 2.18, 5.6, and 7.4 for a discussion of program clusters). In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the significance of the deficiency in relation to the overall major program (program cluster). Following are some examples:

- Significant deficiencies in specific controls over the time cards of college work-study students would likely be considered a reportable condition when college work-study program expenditures are significant in relation to SFA programs.
- Significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would likely be a reportable condition when considered in relation to the total expenditures of R&D programs.
- A deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition.

Chapter 9

AUDIT CONSIDERATIONS OF FEDERAL PASS-THROUGH AWARDS

Introduction

9.1 Many nonfederal entities receiving federal awards make pass-through payments of federal awards to other entities that are considered subrecipients. The amount of those payments may be material to the pass-through entity's financial statements, individual major programs, or both. The auditor's consideration of pass-through federal awards in an audit of both pass-through entities and subrecipients of federal awards under Circular A-133 is discussed in this chapter. The auditee's and auditor's responsibilities with respect to activities carried out by vendors is also discussed in this chapter. An auditee with multiple federal funding agreements may be a pass-through entity in regard to some awards, a subrecipient in regard to other awards, and a vendor with respect to other agreements.

Definitions

9.2 Circular A-133 includes the following definitions that are relevant to pass-through awards:

- *Federal award*—federal financial assistance and federal cost-reimbursement contracts that nonfederal entities receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors.
- *Nonfederal entity*—a state, local government, or non-profit organization (NPO).
- *Recipient*—a nonfederal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program.
- *Pass-through entity*—a nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
- *Subrecipient*—a nonfederal entity that expends federal awards received from a pass-through entity to carry out a federal program but does not include an individual who is a beneficiary of such a program. A subrecipient may also be a recipient of other federal awards directly from a federal awarding agency.
- *Vendor*—a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the federal program.

Applicability of Circular A-133

9.3 Circular A-133 applies to both recipients expending federal awards received directly from federal awarding agencies and subrecipients expending federal awards received from a pass-through entity. Accordingly, both recipients and subrecipients that expend $300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133 (see chapter 11 for a detailed discussion of program-specific audits).

9.4 The determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the disbursement of funds to subrecipients. The activity that requires subrecipients to comply with laws, regulations, and the provisions of contracts or grant agreements is the expenditure of the pass-through award.

9.5 Payments received by a vendor for goods or services provided in connection with a federal program are not considered federal awards. Furthermore, Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered federal awards expended under Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

9.6 If a pass-through entity provides federal awards to subrecipients, the pass-through entity must monitor the subrecipients' activities to provide reasonable assurance that the subrecipients administer federal awards in compliance with federal requirements. As part of the compliance audit, the auditor of the pass-through entity must test and report on subrecipient monitoring (which is one of the fourteen types of compliance requirements in the *Compliance Supplement*—see paragraph 6.22) when federal awards passed through to subrecipients are material to a major program (see paragraphs 9.24 through 9.35). If the federal awards provided are immaterial or relate to a program that is not considered major, the auditor of the pass-through entity has no additional compliance auditing responsibilities related to the funds passed through to subrecipients.

9.7 Most of this chapter focuses on compliance auditing considerations for auditors of pass-through entities. However, paragraphs 9.43 through 9.47 provide additional considerations for auditors of subrecipients.

Pass-Through Entities, Subrecipients, and Vendors

Subrecipient Status Versus Vendor Status

9.8 The responsibilities for compliance with federal program requirements and the applicable compliance requirements to be tested by the auditor are significantly different for pass-through entities, subrecipients, and vendors. Guidance on distinguishing between a subrecipient and a vendor is provided in section 210 of Circular A-133 and is summarized in paragraphs 9.9 through 9.11.

Characteristics Indicative of a Federal Award Received by a Subrecipient

9.9 According to Circular A-133, characteristics indicative of a federal award received by a subrecipient are when the entity (see paragraph 9.12 for examples of the relationship between pass-through entities and subrecipients)—

- Determines who is eligible to receive what federal financial assistance.
- Has its performance measured against whether the objectives of the federal program are met.

- Has responsibility for programmatic decision making.
- Has responsibility for adherence to applicable federal program compliance requirements.
- Uses the federal funds to carry out a program of the entity as compared to providing goods or services for a program of the pass-through entity.

Characteristics Indicative of a Payment for Goods or Services Received by a Vendor

9.10 According to Circular A-133, the characteristics indicative of a payment for goods or services received by a vendor are when the entity (see paragraph 9.13 for examples of the relationship between recipients and vendors)—

- Provides the goods and services within normal business operations.
- Provides similar goods or services to many different purchasers.
- Operates in a competitive environment.
- Provides goods or services that are ancillary to the operation of the federal program.
- Is not subject to the compliance requirements of the federal program.

Use of Judgment in Determining Subrecipient or Vendor Status

9.11 Circular A-133 states that there may be unusual circumstances or exceptions to the listed characteristics in paragraphs 9.9 and 9.10. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present, and judgment should be used in determining whether an entity is a subrecipient or vendor. In some cases, it may be difficult to determine whether the relationship with the entity is that of a subrecipient or of a vendor. The federal cognizant agency for audit, the oversight agency for audit, or the federal awarding agency may be of assistance in making these determinations.

Description of Relationships

Pass-Through Entity and Subrecipient

9.12 Following are examples of a typical relationship between a pass-through entity and a subrecipient:

- A state department of education (pass-through entity) receives a federal award and is responsible for administering and disbursing the federal award to local school districts (subrecipients) according to a formula or some other basis.
- A regional planning commission (pass-through entity) receives a federal award for the feeding of elderly and low-income individuals, and the award is disbursed to NPOs (subrecipients) to support their feeding programs.
- A hospital (subrecipient) receives a federal award from a university (pass-through entity) to conduct research.
- A theater group (subrecipient) receives a federal award from a state arts commission (pass-through entity) to support a summer arts series.

Recipient and Vendor

9.13 Following are examples of a typical relationship between a recipient and a vendor:

- A local government (recipient) receives a federal award to provide mental health services in a designated area. Some of the funds are paid to a contractor (vendor) to repair a leaking roof.
- A county (recipient) receives a federal award to operate a Head Start program and pays a NPO (vendor) to provide temporary clerical services.
- An NPO (recipient) receives a federal award to run a preschool and pays a medical doctor (vendor) to perform health screening on a per-student basis.
- An NPO (recipient) receives a federal award to operate a child care center and pays a not-for-profit clinic (vendor) to perform physical exams.

Entity is Both a Subrecipient and a Pass-Through Entity

9.14 There are instances in which an entity can be both a subrecipient and a pass-through entity as shown in the following examples:

- A local government receives a pass-through federal award from a state government agency (the local government is a subrecipient) and further passes through a portion of the federal award to an NPO (the local government is also a pass-through entity) to administer a federal program.
- A not-for-profit area agency receives a pass-through federal award from a state (the not-for-profit area agency is a subrecipient) and further passes through a portion of the federal award to a for-profit health care provider (the not-for-profit area agency is also a pass-through entity). See paragraph 9.40 for a discussion of a pass-through entity's responsibilities when the subrecipient is a for-profit entity.

Vendor Compliance Considerations

Auditee's Responsibilities

9.15 Circular A-133 states that in most cases, the auditee's compliance responsibility for a vendor is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. A program's compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions that are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine compliance.

Auditor's Responsibilities

9.16 When vendors are responsible for program compliance, the auditor should determine whether vendor transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements if such transactions are material to a major program of the auditee. In such a case, the auditor would normally evaluate a vendor's compliance by reviewing the auditee's records and the results of the auditee's procedures for ensuring compliance by the vendor. When the auditor cannot obtain sufficient assurance from reviewing the auditee's records and procedures, the auditor should consider the need to report a reportable condition. The auditor will also ordinarily need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or obtaining reports on compliance procedures performed by the vendor's independent auditor.

9.17 Prior to performing a single or program-specific audit, it is important for the auditor to understand the nature of the auditee's vendor relationships, whether the vendors are responsible for program compliance, the auditee's procedures for ensuring vendor compliance, and whether it will be necessary for the auditor to test vendor records. The auditor should consider including such information in the communication used to establish an understanding with the auditee (see paragraphs 3.6 and 3.7). If subsequent to undertaking a single or program-specific audit the auditor becomes aware of a significant vendor relationship that will require the auditor to perform additional procedures on vendor records, the auditor should inform the auditee that the requirements of Circular A-133 will not be met unless additional procedures are performed. If the auditee or vendor precludes the auditor from performing such additional procedures, the auditor should qualify his or her opinion or disclaim an opinion because of a scope limitation (see paragraphs 10.43 through 10.45 for a further discussion of scope limitations).

Single Audit Considerations of Pass-Through Entities

9.18 The following matters are relevant to planning and conducting a single audit of a pass-through entity:

- Pass-through entity responsibilities (see paragraph 9.19)
- Audit planning considerations (see paragraphs 9.20 through 9.22)
- Consideration of internal control over compliance (see paragraph 9.23)
- Subrecipient monitoring (see paragraphs 9.24 through 9.35)
- Reporting considerations (see paragraphs 9.36 through 9.39)
- For-profit subrecipients (see paragraph 9.40)
- Non-U.S.-based entities (see paragraph 9.41)
- A state's designation of a cluster of programs (see paragraph 9.42)

Pass-Through Entity Responsibilities

9.19 A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations, and provisions of contracts or grants. Circular A-133 requires a pass-through entity to perform the following for the federal awards it provides to subrecipients:

- Identify the federal awards made by informing each subrecipient of the CFDA title and number, the award's name and number, the award year, whether the award is for R&D, and the name of the federal agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the federal award.
- Advise subrecipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.

- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending $300,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of Circular A-133 for that fiscal year.
- Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate the adjustment of the pass-through entity's own records.
- Require subrecipients to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with Circular A-133.
- Keep subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on the file for three years from the date of receipt (see paragraphs 9.47, 10.76, and 10.78).

Audit Planning Considerations

Impact of Pass-Through Federal Awards on the Determination of Major Programs

9.20 As noted in paragraph 9.4, the determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards provided by a pass-through entity to subrecipients, the federal awards are deemed to be expended by the pass-through entity when the funds are disbursed to subrecipients, regardless of when subrecipients expend the federal funds. Accordingly, the amount of federal funds disbursed to subrecipients should be included in the total expenditures of federal awards of the pass-through entity and in the determination of the pass-through entity's major programs (see chapter 7 for a more detailed discussion of the determination of major programs).

Pass-Through Entity Request for a Program to Be Audited as a Major Program

9.21 When a subrecipient expends $300,000 or more of federal awards, Circular A-133 permits the pass-through entity to request that the program be audited as a major program in lieu of the pass-through entity conducting or arranging for additional audits. If the pass-through entity makes such a request, it is required to pay the full incremental cost for such an audit (see paragraph 2.19 for additional information).

Materiality

9.22 The auditor of the pass-through entity should compare the amount of federal funds passed through to subrecipients with the total expenditures for each individual major program or cluster to determine if the amount is material. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. When the amount of federal funds passed through to subrecipients is material in relation to the major program being audited, the greater the need for the auditor to test the subrecipient-monitoring requirements. It should be noted that some federal programs are designed in such a manner that subrecipient expenditures are intended to be material to the pass-through entity's award. For example, the Community Services Block Grant requires a state to subgrant at least 90 percent of the state's award.

Consideration of Internal Control Over Compliance

9.23 As part of performing procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit of the pass-through entity to support a low assessed level of control risk for major programs, the auditor should consider the pass-through entity's internal control over compliance used to monitor subrecipients (see chapter 8 for an additional discussion of considerations concerning internal control over compliance). Tests of internal control over compliance used to monitor subrecipients may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified in paragraph 9.28. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the internal control over compliance, materiality, and professional judgment. Auditors should consider referring to part 6 of the *Compliance Supplement*, which describes (among other things) certain characteristics of internal control over compliance that, when present and operating effectively, may ensure compliance with program requirements for subrecipient monitoring. The results of the auditor's testing of internal control over compliance assist in determining the nature, timing, and extent of subrecipient monitoring compliance testing.

Subrecipient Monitoring

9.24 The Single Audit Act requires the pass-through entity to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. Since the pass-through entity is held accountable for federal awards administered by their subrecipients, the pass-through entity needs to establish an appropriate subrecipient-monitoring process and to decide what, if any, additional monitoring procedures may be necessary to ensure the subrecipients' compliance. Arrangements for subrecipient monitoring should be made by the pass-through entity in its agreements with subrecipients.

9.25 Auditors must consider subrecipient monitoring in a compliance audit of an entity that disburses to subrecipients federal awards that are material to a major program (see the discussion of materiality in paragraph 9.22). The auditor should consider whether the pass-through entity monitors subrecipients and has established internal control over compliance that provides reasonable assurance that subrecipients are managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of the pass-through entity's major programs.

Compliance Supplement *Guidance*

9.26 One of the fourteen types of compliance requirements included in the *Compliance Supplement* is subrecipient monitoring. The *Compliance Supplement* identifies several audit objectives for subrecipient monitoring. According to the *Compliance Supplement*, in a single audit of a pass-through entity, the auditor should determine whether the pass-through entity—

- Identified the federal award's information and compliance requirements to the subrecipient.
- Monitored the subrecipient's activities to provide reasonable assurance that the subrecipient administered federal awards in compliance with federal requirements.
- Ensured that the required audits were performed, and required appropriate corrective action concerning monitoring and audit findings.
- Evaluated the impact of subrecipient activities on the pass-through entity.

9.27 The *Compliance Supplement* also identifies the suggested audit procedures for testing the compliance audit objectives for pass-through entities (see paragraph 6.44 for a further discussion of suggested audit procedures). The auditor may consider coordinating the subrecipient-related tests performed as part of activities allowed or unallowed (tests that subrecipient agreements were for allowable activities), cash management (tests of cash reports submitted by subrecipients), eligibility (tests that subawards were made only to eligible subrecipients), and procurement (tests of suspension and debarment certifications) with the tests of subrecipient monitoring.

Pass-Through Entity Monitoring Procedures

9.28 The monitoring procedures used by the pass-through entity may include on-site visits, reviews of documentation supporting requests for reimbursement, and limited-scope audits. Section 230(b)(2) of Circular A-133 defines limited-scope audits as agreed-upon procedures engagements that are conducted in accordance with either GAAS or the AICPA attestation standards, and that are paid for and arranged by a pass-through entity and only address one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and reporting. Following are other monitoring procedures that a pass-through entity may perform:

- Reviewing grant applications submitted by subrecipients to determine that—
  - — Applications are filed and approved in a timely manner
  - — Each application contains the condition that the subrecipient comply with the federal requirements set by the federal agency
- Establishing internal control over compliance to provide reasonable assurance that—
  - — Funds are disbursed to subrecipients only on an as-needed basis
  - — Funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis
  - — Refunds that are due from subrecipients are billed and collected in a timely manner
  - — Subrecipients and other entities and individuals receiving federal funds meet eligibility requirements
- Reviewing financial and technical reports received from subrecipients on a timely basis and investigating unusual items

- Reviewing subrecipient audit reports, to evaluate them for completeness and for compliance with applicable laws and regulations
- Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented
- Reviewing previously detected deficiencies and determining that corrective action was taken

Monitoring When the Subrecipient Has a Single or Program-Specific Audit

9.29 As noted in paragraph 9.3, subrecipients that expend $300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133. If subrecipients have a single or program-specific audit, the pass-through entity's receipt and review of the results of that audit and its action on related findings may be sufficient to meet the subrecipient-monitoring requirements of Circular A-133. However, it is more likely that the receipt and review of such audit results should be merely one tool that should be used by the pass-through entity as part of a comprehensive subrecipient-monitoring process. Pass-through entities should be aware that a single audit is likely to provide varying degrees of assurance concerning a particular program. For example, a pass-through award may not have been tested as a major program as part of a subrecipient's audit. For this reason, the pass-through entity should consider the testing and results of the single audit of the subrecipient to determine what effect those results should have on other monitoring procedures employed by the pass-through entity.

9.30 In many cases, the pass-through entity will not have received all the subrecipient audit reports covering the time period being audited at the pass-through entity in time to incorporate the results into its own audit. The reports for the pass-through entity and the subrecipient are not required to be issued simultaneously, but the pass-through entity is required to have internal control over compliance in place, to determine that subrecipient audit reports have been received and that corrective action is taken after the receipt of the subrecipient's audit. If the subrecipient's audit report is current, it need not cover the same period as the pass-through entity's audit. If the pass-through entity has an effective system for monitoring subrecipients, its auditor should be able to rely on the subrecipient's audit cycle, even if it is not coterminous with the pass-through recipient's fiscal year.

Considering Risk Factors When Developing Monitoring Procedures

9.31 The preamble to Circular A-133 states that the OMB expects pass-through entities to consider various risk factors (such as the relative size and complexity of the federal awards administered by subrecipients, the entity's prior experience with each subrecipient, and the cost-effectiveness of various monitoring procedures) in developing subrecipient-monitoring procedures. For example, if a pass-through entity provides a large percentage of the only federal award it expends to ten subrecipients that each expend less than $300,000 in federal awards annually, the pass-through entity should carefully consider the most cost-effective method of monitoring these federal awards. Perhaps the majority of this federal award is provided to two subrecipients. The pass-through entity might consider conducting site visits at these two subrecipients and simply reviewing the documentation supporting requests for reimbursement from the other eight subrecipients. Conversely, if a small percentage of a federal award is provided to subrecipients that each expend less than $300,000 in federal awards, the risk to the pass-through entity is most likely low and, therefore, the monitoring procedures could be minimal.

Unallowable Audit Costs

9.32 For subrecipients that expend less than $300,000 in federal awards annually, the cost of any audits or attestation engagements (other than the limited-scope audits paid for and arranged by a pass-through entity as described in paragraph 9.28), are not allowable costs and, therefore, cannot be charged to any federal award. Accordingly, Circular A-133 would prohibit the cost of a financial statement audit conducted in accordance with GAAS or *Government Auditing Standards* from being charged (by either a pass-through entity or subrecipient) to federal awards for a subrecipient that expends less than $300,000 in federal awards annually. The allowability of audit costs is discussed in greater detail in paragraph 2.12.

When the Subrecipient Monitoring System Is Not Sufficient

9.33 The auditor may determine that the pass-through entity's subrecipient-monitoring system is not sufficient to ensure subrecipient's compliance with laws, regulations, and the provisions of grants and contracts. In this situation, the auditor should report a reportable condition (and possibly a material weakness) and consider whether the insufficient monitoring system represents an instance of noncompliance that should be reported as a compliance finding. The effect of the noncompliance on the opinion on compliance for major programs is primarily a function of the pervasiveness of the lack of monitoring and the materiality of subrecipient funding to a program. For example, if the pass-through entity did not perform subrecipient-monitoring procedures and 90 percent of the program was passed through to subrecipients, an opinion modification would likely be warranted. This would likely be the case even if the scope of the audit was expanded to include additional audit procedures to determine that the subrecipients actually complied with laws and regulations.

9.34 There may be instances in which the pass-through entity asks the auditor to perform additional procedures to determine the compliance of a subrecipient (such as conducting tests of records at the subrecipient's site). This would be considered an expansion of the scope of the audit. The auditor should be aware that such an expansion of the scope of the audit would not be sufficient to remedy the reportable condition (or material weakness) and, if applicable, noncompliance of the pass-through entity's monitoring system. However, an expansion of the scope of the audit may remedy the noncompliance related to the type of compliance requirement being tested (for example, eligibility).

9.35 The auditor should also consider any implications of an insufficient subrecipient-monitoring system on the opinion on the financial statements. If amounts passed through to subrecipients are considered material to the financial statements of the pass-through entity, the auditor should determine whether the report on the financial statements should be modified. Before making this determination, the auditor should take into consideration any evidential matter that may be available to the auditor (such as subrecipients' Circular A-133 audit reports and other financial reports that may have been submitted to the pass-through entity) that could indicate that the subrecipients administered the program in compliance with laws and regulations. Further, the auditor should also consider whether it is necessary to report an internal control or compliance finding in the report issued to meet the requirements of *Government Auditing Standards.*

Reporting Considerations

Schedule of Expenditures of Federal Awards

9.36 Circular A-133 states that, to the extent practical, pass-through entities should identify in the schedule of expenditures of federal awards the total amount provided to subrecipients from each federal program (see chapter 5 for an additional discussion of the schedule). If a pass-through entity is unable to identify amounts provided to subrecipients, the auditor should consider whether a reportable condition (and possibly a material weakness) should be reported. The auditor should also consider whether material noncompliance (for subrecipient monitoring) that is required to be reported as an audit finding has occurred.

Evaluation of Audit Findings

9.37 Circular A-133 requires the auditor to consider a finding in relation to the type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement,* whether or not the finding can be quantified. For example, the auditor may discover that a pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The pertinent audit objective included in the *Compliance Supplement* and relating to this example is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance is material in relation to the audit objective and, therefore, must be reported as an audit finding. In addition, the auditor must consider whether reportable conditions (and possibly, material weaknesses in internal control) exist and require reporting with respect to subrecipient monitoring.

Effect of Subrecipients' Noncompliance on the Pass-Through Entity's Report

9.38 The instances of noncompliance reported in subrecipients' audit reports are not required to be included in the pass-through entity's audit report. However, the auditor of the pass-through entity should consider the effects of reported instances of subrecipient noncompliance or indications of weaknesses in the pass-through entity's subrecipient-monitoring system that could have a material effect on each of the pass-through entity's major programs.

Adjustment of Pass-Through Entity Financial Records and Reports

9.39 Questioned costs at the subrecipient level that are found to be unallowable by the pass-through entity may require the pass-through entity to adjust its financial records and its federal expenditure reports. The total of allowable program costs in excess of required expenditure levels and the requirements of individual programs regarding the timing of claims will affect whether the pass-through entity will need to reflect a liability to the awarding agency in its financial statements. As part of the finding-resolution process, the pass-through entity should estimate the total unallowable costs that are associated with each subrecipient finding and consider the need to adjust financial records and federal expenditure reports. The failure of the pass-through entity to adjust its records and federal reports should be considered by the auditor in forming an opinion on compliance for major programs.

For-Profit Subrecipients

9.40 Since Circular A-133 does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. Circular A-133 states that the contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits. The auditor's responsibilities related to for-profit subrecipients are similar to those of not-for-profit subrecipients, see paragraphs 9.24 through 9.35 (as applicable) for a further discussion of subrecipient monitoring.

Non-U.S.-Based Entities

9.41 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient (see paragraph 2.6 for a further discussion of non-U.S.-based entities). Therefore, the responsibilities that a pass-through entity and its auditor have for a non-U.S.-based entity are the same as those for a for-profit subrecipient (see paragraph 9.40).

State Designation of a Cluster of Programs

9.42 Circular A-133 includes a provision that allows a state to designate as a cluster a grouping of closely related programs that share common compliance requirements. When designating a cluster of programs, a state is required by Circular A-133 to identify the federal awards included in the cluster and to advise subrecipients of the compliance requirements applicable to the cluster. See paragraphs 1.18, 1.19, 2.18, 5.6, 7.4, and 8.30 for additional discussion of clusters.

Circular A-133 Audit Considerations of Subrecipients

9.43 Auditors of subrecipients should be aware that subrecipients have additional considerations under Circular A-133. These considerations are related to additional compliance requirements established by the pass-through entity, information included in the schedule of expenditures of federal awards, audit findings, and the submission of the report.

Additional Compliance Requirements Established by Pass-Through Entities

9.44 Federal awards are normally distributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency and, in some instances, additional requirements established by the pass-through entity. Hence, in addition to providing an audit satisfying the requirements of Circular A-133, the auditor may be engaged to test compliance with requirements specified by the pass-through entity.

Information Included in the Schedule of Expenditures of Federal Awards

9.45 For federal awards received as a subrecipient, the schedule of expenditures of federal awards is required to include the name of the pass-through entity and identifying number assigned by the pass-through entity. Circular A-133 states that to make the schedule easier to use, subrecipients may choose to provide information requested by federal awarding agencies and pass-through entities, although this information is not required. Chapter 5 includes more detailed information about the schedule.

Audit Findings

9.46 Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Circular A-133 states that where practical, audit findings should be organized by federal agency or pass-through entity (see chapter 10 for an additional discussion of audit findings).

Submission of Report

9.47 Section 320(e) of Circular A-133 has additional report-submission responsibilities for subrecipients. When a subrecipient is not required to submit a reporting package to the pass-through entity (because it has no audit findings or the summary schedule of prior audit findings does not report the status of any audit findings), the subrecipient is required to provide written notification of this to the pass-through entity. The required contents of the written notification and the submission of the report by subrecipients are discussed in paragraph 10.76.

Chapter 10

AUDITOR REPORTING REQUIREMENTS AND OTHER COMMUNICATION CONSIDERATIONS IN A SINGLE AUDIT

Overview

10.1 In this chapter the auditor's reporting requirements and other communication considerations in a single audit under Circular A-133 are discussed. The auditor's reporting requirements in a program-specific audit are discussed in chapter 11.

10.2 The auditor's reporting responsibilities in a single audit are driven by the three levels of auditing standards and requirements: GAAS, *Government Auditing Standards*, and Circular A-133. These standards and requirements expand the level of auditor responsibility from reporting on an auditee's financial statements to also reporting on internal control and on compliance. The auditor has additional reporting responsibilities for the audit of the financial statements in accordance with *Government Auditing Standards* (see chapter 4), and for the compliance audit applicable to major programs in accordance with Circular A-133 (see chapters 6 through 8). The auditor also has additional communication considerations under GAAS and *Government Auditing Standards* related to matters noted in the single audit.

Circular A-133 Requirements

Auditor's Reports

10.3 Circular A-133 requires the auditor's report(s) to include—

- An opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (see paragraph 10.12 for a discussion of the basis of accounting) and an opinion (or a disclaimer of opinion) on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- A report on the internal control related to the financial statements and on the internal control related to major programs. This report must describe the scope of testing of internal control and the results of the tests and, where applicable, must refer to the separate schedule of findings and questioned costs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report must also include an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program, and where applicable, must refer to the separate schedule of findings and questioned costs.

- A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67).

The auditor's reports recommended in this SOP are described in paragraphs 10.8 through 10.10 below.

Data Collection Form

10.4 Circular A-133 also requires the auditor to complete applicable sections and sign a data collection form that summarizes the auditor's results, findings, and questioned costs (see paragraphs 10.71 through 10.73).

Other Communication Considerations

10.5 The auditor has certain additional communication considerations under GAAS and *Government Auditing Standards* related to internal control, noncompliance, fraud, illegal acts, and other matters noted in the single audit (see paragraphs 10.13 through 10.30).

Reporting Package

10.6 The auditee is required to submit a reporting package that includes the following:

- Financial statements and a supplementary schedule of expenditures of federal awards (see chapters 4 and 5);
- Auditor's reports (see paragraphs 10.8 through 10.10);
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70);
- A corrective action plan (see paragraphs 10.68 through 10.70).

10.7 Although not part of the reporting package, the report submission to the Federal Audit Clearinghouse (FAC) must also include the data collection form described in paragraphs 10.71 through 10.73. The requirements for report submission are discussed in paragraphs 10.74 through 10.79.

Recommended Auditor's Reports

10.8 Reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued:

a. An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards (see paragraph 10.35 through 10.37)[1]

b. A report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* (see paragraphs 10.38 through 10.40)

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[1] Note that in certain circumstances the auditor may report on the schedule of expenditures of federal awards in his or her report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133. See paragraph 10.36 for a further discussion.

c. A report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133 (see paragraphs 10.46 through 10.54)

d. A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67)

10.9 Example reports are provided in appendix D of this SOP. As noted previously, those reports combine reports on compliance and internal control at the financial statement audit level and at the major program compliance audit level. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. The basic elements of each of the recommended reports are discussed later in this chapter. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

10.10 Table 10.1 provides a matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133.

Table 10.1

Recommended Reporting in Single Audits

	Required by—		
Report	*GAAS*	Government Auditing Standards	*Circular A-133*
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or a disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Reporting on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards in Accordance With GAAS and *Government Auditing Standards*

10.11 In this section the reporting and additional communication requirements under GAAS and *Government Auditing Standards* that are related to a financial statement audit and the supplementary schedule of expenditures of federal awards are discussed.

Basis of Accounting

10.12 Circular A-133 and *Government Auditing Standards* do not prescribe the basis of accounting that must be used by auditees to prepare their financial statements and the schedule of expenditures of federal awards. However, auditees are required to disclose the basis of accounting and the significant accounting policies used in preparing the financial statements and the schedule of expenditures of federal awards. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts included in the schedule of expenditures of federal awards. The auditor is required to report whether the financial statements are presented fairly in all material respects in conformity with GAAP and whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole (see paragraphs 4.3 and 10.13 for a discussion of the auditor's responsibilities when the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP).

GAAS Requirements

10.13 The applicable reporting requirements are established in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). For an auditee that prepares its financial statements in conformity with a basis of accounting other than GAAP, auditors should follow the guidance in SAS No. 62, *Special Reports*. In reporting on the supplementary schedule of expenditures of federal awards, auditors should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Auditors may also refer to the AICPA Audit and Accounting Guides *Not-For-Profit Organizations, Audits of State and Local Governmental Units, Health Care Organizations*, and *Audits of Colleges and Universities*[2] for additional guidance on reporting on the financial statements of specific industries. See also paragraphs 10.17 through 10.30 for a discussion of additional reporting and communication requirements.

10.14 SAS No. 61, *Communication With Audit Committees*, requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for the oversight of the financial reporting process. Matters to be communicated include (among other things) the auditor's responsibilities, significant accounting policies, management judgments and accounting estimates, significant audit adjustments, disagreements with management, and difficulties encountered in performing the audit. In addition to the SAS No. 61 requirements described above, *Government Auditing Standards* also requires the auditor to communicate certain information to the audit committee. See paragraph 10.16 for a further discussion.

Government Auditing Standards *Requirements*

10.15 Government Auditing Standards requires that in addition to reporting on the financial statements, the auditor report on (1) compliance with laws, regulations, and provisions of contracts and grant agreements that could

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[2] Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

have a direct and material effect on the financial statements amounts and (2) the scope of testing of the auditee's internal control over financial reporting and on the results of the tests.

10.16 The reporting standards for financial audits in *Government Auditing Standards* contain five additional reporting standards for financial statement audits beyond GAAS (see also paragraphs 3.19 through 3.21):

a. Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. Such matters include the auditor's responsibility in a financial statement audit, as well as the nature of any additional testing of internal control and compliance required by laws or regulations. To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal control and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance. The communication may be oral or in writing. If the information is communicated orally, the auditor is required to document the communication in the working papers (see paragraphs 5.5 through 5.10 of *Government Auditing Standards* and paragraphs 3.19 through 3.20 of this SOP for a further discussion).

b. When the report on the financial statement is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. This SOP recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."[3] *Government Auditing Standards* also acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS (see paragraphs 5.11 through 5.14 of *Government Auditing Standards*).

c. The report on the audit of the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal control and present the results of those tests or (2) refer to separate reports containing that information (see paragraphs 5.15 through 5.28 of *Government Auditing Standards*). The financial statement reporting recommended in this SOP (appendix D, examples 1 and 1a), illustrates the second option to refer to a separate report on compliance with certain provisions of laws, regulations, contracts, and grants and on internal control over financial reporting. In presenting the results of tests, the auditor should report

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[3] The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

fraud, illegal acts, other material noncompliance, and reportable conditions in internal control (see paragraphs 10.17 through 10.30). In some circumstances, the auditor should report fraud and illegal acts directly to parties external to the audited entity (see paragraphs 10.23 through 10.25).

d. If certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary (see paragraphs 5.29 through 5.31 of *Government Auditing Standards*).

e. Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it.[4] Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection (see paragraphs 5.32 through 5.35 of *Government Auditing Standards*).

Fraud, Illegal Acts, and Other Noncompliance

GAAS Requirements

10.17 In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.17), the auditor's responsibilities with respect to the consideration of illegal acts,[5] including communications with the audit committee or others with equivalent authority or responsibility are discussed.[6] Paragraph 17 of SAS No. 54, requires the auditor to assure himself or herself that the audit committee or others with equivalent authority and responsibility are adequately informed with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements. If senior management is involved, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it. Paragraphs 4.24 through 4.31 summarize the other requirements of SAS No. 54. The auditor should also consider the effect of any noncompliance on the financial statements, and should modify the auditor's report on those financial statements as necessary in accordance with SAS No. 58.

10.18 The auditor's responsibilities for communications about fraud to management, the audit committee, and others based on a financial statement

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[4] Note that when public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately.

[5] SAS No. 54 defines the term *illegal acts* as violations of laws or government regulations.

[6] For auditees that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

audit in accordance with GAAS are discussed in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the auditee's organization. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. The disclosure of possible fraud to parties other than the auditee's senior management and its audit committee is ordinarily not part of the auditor's responsibility and would ordinarily be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the auditee may exist:

- To comply with certain legal and regulatory requirements
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- In response to a subpoena
- To a funding agency or other specified agency in accordance with the requirements for audits of entities that receive governmental financial assistance (see paragraphs 10.23 through 10.25)

10.19 When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions that relate to the auditee's internal control and that should be communicated to senior management and the audit committee (see paragraphs 10.26 through 10.30). The auditor may also wish to communicate other risk factors that are identified, when the auditee can reasonably take actions to address the risk.

10.20 In paragraphs 38 through 40 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.38–.40), the communication requirements of SAS No. 82 are further discussed. In paragraphs 4.32 through 4.37 of this SOP, the other requirements of SAS No. 82 are summarized. See paragraphs 6.7 through 6.12 for a discussion of the auditor's consideration of fraud risk in an audit of an auditee's compliance with specified requirements applicable to its major programs.

Government Auditing Standards *Requirements*

10.21 With regard to fraud and illegal acts, *Government Auditing Standards* requires auditors to report relevant information (in writing) when the auditor concludes, based on evidence obtained, that fraud or an illegal act has occurred or is likely to have occurred.[7] Auditors do not need to report information about fraud or illegal acts that is clearly inconsequential. Therefore, auditors are required to present in the report the same fraud and illegal acts that they report to audit committees under GAAS (see paragraphs 10.17 through 10.20). *Government Auditing Standards* also requires auditors to report other

[7] The term *fraud*, as used in SAS No. 82, is synonymous with *irregularities* as used in *Government Auditing Standards*. Therefore, in discussing the requirements of *Government Auditing Standards*, this SOP will use the term *fraud* instead of the term *irregularities*.

noncompliance (for example, a violation of a contract provision) that is material to the financial statements. In presenting fraud, illegal acts, or other noncompliance that are required to be reported, auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* for objectives, scope, and methodology; audit results; the views of responsible officials; and report presentation standards (as appropriate).

10.22 When auditors detect fraud, illegal acts, or other noncompliance that do not meet the criteria in paragraph 5.18 of *Government Auditing Standards* for reporting (summarized in paragraph 10.21), paragraph 5.20 of *Government Auditing Standards* requires auditors to communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they are reporting on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, or other noncompliance.

Direct Reporting of Fraud and Illegal Acts

10.23 Paragraphs 5.21 through 5.25 of *Government Auditing Standards* provide guidance on the direct reporting of fraud and illegal acts. *Government Auditing Standards* requires that in addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors must report fraud or illegal acts directly to parties outside the auditee in the following two circumstances (auditors should meet these requirement even if they have resigned or been dismissed from the audit):

a. The auditee may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the auditee, and it fails to report them, then auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.

b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

10.24 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

10.25 Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require them to report indications of certain types of fraud or illegal acts promptly to law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

Internal Control Over Financial Reporting

10.26 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance in identifying and reporting conditions that relate to an auditee's internal control observed during an audit of financial statements. In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to the internal control over financial reporting during the course of the audit rather than after the audit is concluded.

10.27 Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of the internal control over financial reporting as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. The report does not express an opinion on the auditee's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55. The report includes the requirements of SAS No. 60, as well as the additional requirements of *Government Auditing Standards*.

10.28 With regard to matters noted in an audit that relate to the internal control over financial reporting, paragraph 5.26 of *Government Auditing Standards* requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in example 2 of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit. In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. Auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* when reporting reportable conditions or material weaknesses. The illustrative report in example 2a of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

10.29 Paragraph 5.28 of *Government Auditing Standards* states that when auditors detect deficiencies in the internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control (examples 2 and

2a of appendix D illustrate such a reference to the management letter). All communications to the auditee about deficiencies in the internal control should be documented in the working papers.

10.30 The following table summarizes the differences between SAS No. 60 and *Government Auditing Standards* with respect to reporting internal control matters.

	Government Auditing Standards	*SAS No. 60*
When is reporting required?	In every financial statement audit	When reportable conditions are noted
What is the form of the report?	Written	Oral or written, preferably in writing
Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses?	Yes	Permitted but not required

Reporting When Portions of a Governmental Reporting Entity Do Not Have an Audit in Accordance With Government Auditing Standards

10.31 Since the implementation of Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, it is becoming more frequent for governments that are required to have an audit in accordance with *Government Auditing Standards* to include as part of the reporting entity component units that are not required to have such an audit. When this occurs, the auditor should consider modifying his or her report on the financial statements and also the report issued to meet the requirements of *Government Auditing Standards.*

10.32 With regard to the report on the financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the financial statements is required to state that the audit was performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards.* Example wording that could be used in this situation follows:

> We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [*name of fund or component unit*] were not audited in accordance with *Government Auditing Standards*. An audit includes examining . . . .

10.33 With regard to the report issued on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards,* the auditor should modify the scope paragraph of example 2 or 2a of appendix D to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

> We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The financial statements of [*name of fund or component unit*] were not audited in accordance with *Government Auditing Standards*.

Implementing Regulations of Certain Federal Awarding Agencies May Define Entity to Be Audited Differently Than GAAP

10.34 The regulations implementing Circular A-133 may define the entity to be audited for single audit purposes differently than the reporting entity would be defined in accordance with GAAP. For example, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, requires presentation of consolidated financial statements when one NPO (the parent) controls the voting majority of the Board of and has an economic interest in another NPO. If the regulations of the federal agency that provides federal awards to the parent define the entity for single audit purposes to consist of only the parent, audited parent-only financial statements instead of consolidated financial statements must be submitted to comply with these regulations. If consolidated financial statements are not also prepared as required by GAAP, the auditor should consider whether other than an unqualified opinion due to a material departure from GAAP should be expressed on the parent-only financial statements. See paragraphs 35 through 60 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.35–.60) for guidance on reporting when there is a departure from GAAP.

Opinion on the Financial Statements and on the Supplementary Schedule of Expenditures of Federal Awards

Report Requirements

10.35 The auditor's standard report on the financial statements and on the supplementary schedule of expenditures of federal awards identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements and supplementary schedule of expenditures of federal awards in separate opinion paragraphs. The basic elements of the report are—

a. A title that includes the word *independent*.

b. A statement that the financial statements identified in the report were audited.

c. A statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.

d. A statement that the audit was conducted in accordance with GAAS and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.[8]

e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

f. A statement that an audit includes—
- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
- Assessing the accounting principles used and significant estimates made by management.
- Evaluating the overall financial statement presentation.

g. A statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.

h. For a government, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the balance sheet date, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the period then ended in conformity with GAAP; for a not-for-profit organization, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the date of the statement of financial position, and the changes in its net assets and its cash flows for the period then ended in conformity with GAAP.[9]

i. A reference to the separate report on compliance with certain provisions of laws, regulations, contracts, and grant agreements and on the internal control over financial reporting prepared in accordance with *Government Auditing Standards*.[10] If this reporting is included in the report on the financial statements, this reference is not required (this SOP recommends separate reporting). See paragraph 10.16.

j. A description of the accompanying supplementary information (for example, the schedule of expenditures of federal awards, combining and individual fund and account group financial statements and schedules, etc.). This identification may be by descriptive title or by page number of the document.

k. A statement that the accompanying supplementary information, including the schedule of expenditures of federal awards required by Circular A-133, is presented for purposes of additional analysis and is not a required part of the financial statements.[11] See paragraph 10.36.

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[8] See footnote 3.

[9] If an auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the reporting in SAS No. 62, *Special Reports*.

[10] See paragraphs 10.15, 10.16, and 10.21 through 10.30 for a discussion of reporting on compliance and on the internal control based on a financial statement audit in accordance with *Government Auditing Standards*.

[11] If the report on the financial statements is issued for an audit that is not subject to Circular A-133 (that is, an audit in accordance with GAAS and *Government Auditing Standards* only), this reference to the schedule of expenditures of federal awards and Circular A-133 should be deleted.

l. An opinion on whether the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

m. The manual or printed signature of the auditor's firm.

n. The date of the audit report.

Reporting on the Schedule of Expenditures of Federal Awards

10.36 This SOP recommends that the auditor report on the schedule of expenditures of federal awards in the report on the financial statements. However, some entities do not present the schedule with the financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate how to incorporate the reporting on the schedule into the Circular A-133 report. See also paragraphs 10.50 through 10.52 for information on dating the reports in this situation and paragraph 10.13 for a further discussion of reporting on the schedule.

10.37 Examples of the auditor's opinion on the financial statements and on the supplementary schedule of expenditures of federal awards are presented in examples 1 and 1a of appendix D.

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards

10.38 This SOP recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one report (see paragraphs 10.8 through 10.10).

10.39 The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting (see paragraph 4.12) based on an audit of the financial statements in accordance with *Government Auditing Standards* are—

a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.

b. A statement that the audit was conducted in accordance with GAAS and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.[12]

c. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

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[12] See footnote 3.

d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.

e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*[13] and, if they are, describes the instances of noncompliance or refers to the schedule of findings and questioned costs in which they are described.[14]

f. If applicable, a statement that certain immaterial instances of noncompliance were communicated to management in a separate letter.[15]

g. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.

i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

j. If applicable, a description of the reportable conditions noted or a reference to the schedule of findings and questioned costs in which the reportable conditions are described.[16]

k. The definition of a material weakness.

l. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, describes the material weaknesses noted or refers to the schedule of findings and questioned costs in which they are described.[17] If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.

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[13] See paragraph 10.21 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.

[14] For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), any reportable instances of noncompliance, reportable conditions, and material weaknesses can either be described in the body of the report or the report can refer to a separate schedule that summarizes the findings noted. This statement should be modified accordingly. For an audit in accordance with Circular A-133, all findings, including those required to be reported under *Government Auditing Standards*, must be included in the schedule of findings and questioned costs.

[15] See paragraph 10.22 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.

[16] See footnote 14.

[17] See footnote 14.

m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter.[18]

n. A statement that the report is intended for the information of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities.[19] If the report is a matter of public record, a statement should be added that the report is a matter of public record and its distribution is not limited.[20]

o. The manual or printed signature of the auditor's firm.

p. The date of the auditor's report.

10.40 Examples of the auditor's report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are included in examples 2 and 2a of appendix D.

Reporting on a Compliance Audit of Major Federal Programs

10.41 In this section the auditor's reports that are issued based on a compliance audit of major programs in accordance with Circular A-133 are discussed. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the requirements that, if noncompliance occurred, could have a direct and material effect on a major program. Although the guidance in SAS No. 58 addresses reporting on audited financial statements, auditors may find its guidance useful when reporting on a compliance audit of major programs.

Material Instances of Noncompliance

10.42 When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report (see examples 3a and 5 of appendix D). The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. See paragraphs 6.13 through 6.16 for a further discussion of material instances of noncompliance.

Scope Limitations

10.43 Testing an auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements (referred to as "compliance require-

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[18] See paragraph 10.29 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.

[19] For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), the reference to federal awarding agencies and pass-through entities should be deleted.

[20] When the report is not a matter of public record because of legal or other restrictions, this statement should not be added.

ments") requires the auditor to make a comply/noncomply decision about an auditee's adherence to those compliance requirements. The auditor is able to express an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit—whether imposed by the client or by circumstances such as the timing of the auditor's work, an inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records—may require auditors to qualify their opinion or to disclaim an opinion. In these instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor's report. Furthermore, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements. See example 4 of appendix D for an illustration of a qualified opinion on compliance due to a scope limitation.

10.44 The auditor's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance.

10.45 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph all of the substantive reasons for the disclaimer. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should disclose any reservations he or she has regarding compliance with applicable laws and regulations.

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With Circular A-133

Report Requirements

10.46 The basic elements of the auditor's standard report on compliance with requirements applicable to each major program and on the internal control over compliance (see paragraph 4.12) in accordance with Circular A-133 are—

a. A statement that the auditor has audited the compliance of the auditee with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major programs.

b. A statement that the auditee's major programs are identified in the summary of the auditor's results section of the accompanying schedule of findings and questioned costs (see paragraph 10.56).

c. A statement that compliance with the requirements of laws, regulations, contracts, and grants applicable to each of the auditee's major federal programs is the responsibility of the auditee's management, and that the auditor's responsibility is to express an opinion on the auditee's compliance based on the audit.

d. A statement that the audit of compliance was conducted in accordance with GAAS, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States,[21] and Circular A-133.

e. A statement that those standards and Circular A-133 require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.

f. A statement that an audit includes the examining, on a test basis, evidence about the auditee's compliance with those requirements and performing of such other procedures as the auditor considered necessary in the circumstances.

g. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.

h. A statement that the audit does not provide a legal determination of the auditee's compliance with those requirements.

i. If instances of noncompliance are noted that result in an opinion modification, a reference to a description in the accompanying schedule of findings and questioned costs, including—
- The reference number(s) of the finding(s).
- An identification of the type(s) of compliance requirements and related major program(s).
- A statement that compliance with such requirements is necessary, in the auditor's opinion, for the auditee to comply with the requirements applicable to the program(s).

j. An opinion on whether the auditee complied, in all material respects, with the types of compliance requirements that are applicable to each of its major federal programs.

k. If applicable, a statement that the results of the auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with Circular A-133 and a reference to the schedule of findings and questioned costs in which they are described.[22]

l. A statement that the auditee's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs.

m. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over compliance with requirements that could have a direct and material effect on a major

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[21] See footnote 3.

[22] See paragraph 10.63 for a discussion of the audit findings that are required to be reported under Circular A-133.

federal program, to determine the auditing procedures for the purpose of expressing an opinion on compliance and to test and report on the internal control over compliance in accordance with Circular A-133.

n. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.

o. If applicable, a reference to a description of reportable conditions noted in the accompanying schedule of findings and questioned costs, including the reference number of the finding(s).

p. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

q. The definition of a material weakness.

r. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, a reference to a description of the material weaknesses in the schedule of findings and questioned costs, including the reference number of the finding(s). If there are no reportable conditions, a statement is made that no material weaknesses were noted.

s. A statement that the report is intended for the information of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities. If the report is a matter of public record, a statement should be added that the report is a matter of public record and its distribution is not limited.[23]

t. The manual or printed signature of the auditor's firm.

u. The date of the auditor's report.

Option to Report on the Schedule of Expenditures of Federal Awards

10.47 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, in certain circumstances (for example, when a separate single-audit package is issued), the required reporting on the schedule may be incorporated into the report described in paragraph 10.46. See paragraph 10.36 for a further discussion. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate this reporting option.

No Requirement to Refer to Management Letter

10.48 It is important to note that all audit findings required to be reported under Circular A-133 must be included in the schedule of findings and ques-

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[23] When the report is not a matter of public record because of legal or other restrictions, this statement should not be added.

tioned costs (see paragraphs 10.55 and 10.56). A separate letter (that is, management letter) may not be used to communicate such matters to top management in lieu of reporting them as audit findings in accordance with Circular A-133. Since all reportable findings are included in the schedule, there is no requirement for the auditor to refer to the management letter in the report described in paragraph 10.46.

10.49 An example of the auditor's report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133 is presented in examples 3, 3a, 4, and 5 of appendix D.

Other Reporting Considerations

Dating of Reports

10.50 Since the report on the supplementary schedule of expenditures of federal awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as that on the report on these statements. Furthermore, since the report on compliance and internal control over financial reporting, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should also carry the same date.

10.51 The auditor's report on compliance and on the internal control over compliance related to major programs, as required by Circular A-133, should ordinarily have the same date as that of the other reports, but may carry a later date, because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the fieldwork required to support the report on the audit of compliance is completed). The auditor should perform subsequent events procedures from the date of the report on the financial statements to the date of the report on the compliance audit in accordance with SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). If, after issuing the report on the financial statements, the auditor becomes aware of instances of noncompliance that could be material to such statements, he or she should follow the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561).

10.52 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, as noted in paragraphs 10.36 and 10.47, there may be circumstances in which the auditor reports on the schedule in the report on compliance and the internal control over compliance issued to meet Circular A-133 requirements. In this situation, the report issued to meet Circular A-133 requirements must be dated the same as the report on the financial statements. This is because the report on the schedule is "in relation to" the basic financial statements. If using the same date is not possible because the work to satisfy Circular A-133 requirements is not complete as of the date of the financial statement report, the auditor has two options:

a. The auditor can dual date the report issued to meet Circular A-133 requirements. The date relating to the portion of the report pertaining to the schedule of expenditures of federal awards would be the same as the date of the financial statement report. The date pertaining to the remainder of the report would be the date on which the work done to satisfy Circular A-133 requirements is completed. Refer to SAS No. 1, section 530 *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530).

b. The auditor can issue a separate report on the schedule of expenditures of federal awards, dated the same date as that of the financial statement report.

In some instances, the auditor may be engaged to issue a stand-alone opinion on the schedule either as part of the report issued to meet the requirements of Circular A-133 or separately (dated the same as the Circular A-133 report). The auditor should follow the guidance in SAS No. 58 when issuing such a report.

Other Auditors

10.53 When more than one independent auditor is involved in a single audit performed under Circular A-133, the auditor should refer to guidance in paragraphs 12 and 13 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.12 and .13) regarding an opinion on financial statements based in part on the report of another auditor, as well as SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543).

When the Audit of Federal Awards Does Not Encompass the Entirety of the Auditee's Operations

10.54 If the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph following the first paragraph of the report on major programs (see also the discussion in paragraph 3.25). An example of such a paragraph follows:

> Example Entity's general-purpose financial statements include the operations of the [*identify component unit or department*], which received [*include dollar amount*] in federal awards which is not included in schedule during the year ended June 30, 19X1. Our audit, described below, did not include the operations of [*identify component unit or department*] because [*state the reason for the omission, such as the component unit engaged other auditors to perform an audit in accordance with OMB Circular A-133*].

Schedule of Findings and Questioned Costs

10.55 Circular A-133 requires the auditor to prepare a schedule of findings and questioned costs, which should include the following three sections:

a. A summary of the auditor's results

b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards*

c. Findings and questioned costs for federal awards

What Should Be Reported

10.56 Specifically, Circular A-133 requires the schedule of findings and questioned costs to contain—

a. A summary of the auditor's results, which must include—

- The type of report the auditor issued on the financial statements of the auditee (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
- Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.[24]
- A statement on whether the audit disclosed any noncompliance that is material to the financial statements of the auditee.
- Where applicable, a statement that reportable conditions in the internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.[25]
- The type of report the auditor issued on compliance for major programs (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
- A statement on whether the audit disclosed any audit findings that the auditor is required to report under section 510(a) of Circular A-133 (see paragraph 10.63).
- An identification of major programs.
- The dollar threshold used to distinguish between type A and type B programs as described in section 520(b) of Circular A-133 (see paragraphs 7.4 through 7.9).
- A statement on whether the auditee qualified as a low-risk auditee under section 530 of Circular A-133 (see paragraph 7.25).

b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards* (see the discussion in paragraphs 10.57 through 10.62 for further detail).

c. Findings and questioned costs for federal awards, which must include audit findings as defined in section 510(a) of Circular A-133 (see paragraph 10.63). Circular A-133 also requires the following with regard to this section of the schedule:

- Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by federal agency or pass-through entity.
- Audit findings that relate to both the financial statements and the federal awards should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form, with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects the auditee as a whole, including its federal awards, should usually be reported in detail

[24] Auditors should note that SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, precludes an auditor from issuing a written report representing that no reportable conditions were noted during an audit. Therefore, the sample schedule of findings and questioned costs included in appendix E uses the term "none reported" to indicate that no reportable conditions were included in the auditor's report (versus "none," which would imply that there were no reportable conditions).

[25] See footnote 24.

in the section of the schedule of findings and questioned costs that is related to the financial statements, with a summary identification and reference given in the section related to federal awards. Conversely, a finding of noncompliance with a federal program law that is also material to the financial statements should be reported in detail in the federal awards section of the schedule, with a summary identification and reference given in the financial statement section.

Findings Relating to the Financial Statements

10.57 As noted before, Circular A-133 requires the schedule of findings and questioned costs to include a section that reports the findings relating to the financial statements (note that these findings must also be addressed in the auditor's report issued to meet the requirements of *Government Auditing Standards*—see paragraphs 10.15, 10.16, and 10.21 through 10.30). This section of the schedule should include all reportable conditions in the internal control over financial reporting and other findings relative to the audit of the financial statements that are required to be reported by GAAS and *Government Auditing Standards*, including those that do not affect federal awards. In addition to requiring auditors to report reportable conditions in the internal control over financial reporting, *Government Auditing Standards* requires auditors to report all but clearly inconsequential fraud and illegal acts that the auditor concludes, based on the evidence obtained, either occurred or are likely to have occurred. *Government Auditing Standards* also requires the auditor to report other noncompliance (for example, violations of the provisions of contract or grant agreements) that is material to the financial statements (see paragraphs 10.21 and 10.22).

10.58 In reporting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. To give the reader a basis to judge the prevalence and consequences of these conditions, the instances that are identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. Reportable conditions that are—either individually or in the aggregate—material weaknesses should be so identified.

10.59 *Government Auditing Standards* suggests that well-developed findings generally include the following elements:

- Criteria (what should be)
- The condition (what is)
- The effect (the difference between what is and what should be)
- The cause (why it happened)

10.60 *Government Auditing Standards* recognizes reportable conditions and noncompliance identified by the auditor may not always have all of the elements fully developed. However, to provide sufficient information to users to permit them to determine the effect and cause in order to take prompt and proper corrective action, auditors should identify at least the criteria, condition, and possible asserted effect.

10.61 In presenting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should follow the report content standards in chapter 7 of *Government Auditing Standards* that pertain to objectives, scope, and methodology; audit results; the views of responsible officials; and the reports presentation standards (as appropriate). Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.

10.62 *Government Auditing Standards* also requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit (see paragraph 6.65 for a discussion of the auditor's responsibility for audit follow-up under *Government Auditing Standards*). The auditor should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Material findings and recommendations from previous audits that are repeated as current-year findings should be identified as repeat findings. If there are uncorrected findings from previous audits that are not repeated as current-year findings, their status should also be reported by the auditor. In either case, this information should be provided for in the section of the schedule of findings and questioned costs related to the financial statements.

Audit Findings Reported—Federal Awards

10.63 Section 510(a) of Circular A-133 requires the auditor to report as audit findings in the schedule of findings and questioned costs—

a. Reportable conditions in the internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or to an audit objective identified in the *Compliance Supplement*. The auditor should identify reportable conditions that are individually or cumulatively material weaknesses (see paragraphs 8.25 and 8.26).

b. Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement* (see paragraphs 6.51 through 6.60 for a further discussion of the evaluation and reporting of noncompliance).

c. Known questioned costs that are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor should consider the best estimate of the total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor should also report (in the schedule of findings and questioned costs) known questioned costs when likely questioned costs are greater than $10,000 for a type of compliance requirement for a major program. For example, if the auditor specifically identifies $7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, estimates that the total questioned costs are in the $50,000–$60,000 range, the auditor should report a finding that identifies the known questioned costs of $7,000. Although the auditor is not required to report his or her estimate of the total questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

d. Known questioned costs that are greater than $10,000 for programs that are not audited as major. Since (except for audit follow-up) the auditor is not required to perform audit procedures for federal programs that are not major, the auditor will normally not find questioned costs. However, if the auditor does become aware of questioned costs for a federal program that is not audited as a major program (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than $10,000, then the auditor should report this as an audit finding.

e. The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not otherwise reported as a finding).

f. Known fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards* (see paragraphs 10.23 through 10.25).

g. Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with section 315(b) of Circular A-133 materially misrepresents the status of any prior audit finding (see paragraphs 10.68 through 10.70).

Detail of Audit Findings—Federal Awards

10.64 Section 510(b) of Circular A-133 requires that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The specific information that Circular A-133 requires in audit findings consists of (as applicable)—

a. Identification of the federal program and specific federal award including the CFDA title and number, the federal award number and year, the name of federal agency, and the name of the applicable pass-through entity. When information such as the CFDA title and number or the federal award number is not available, the auditor should provide the best information available to describe the federal award.

b. The criteria or specific requirement upon which the audit finding is based, including the statutory, regulatory, or other citation.

c. The condition found, including facts that support the deficiency identified in the audit finding.

d. Identification of questioned costs and how they were computed.

e. Information to provide a proper perspective for judging the prevalence and consequences of the audit findings, (for example, whether the audit findings represent an isolated instance or a systemic problem). Where appropriate, the instances identified should be related to the universe and the number of cases examined and be quantified in terms of the dollar value.

f. The possible asserted effect to provide sufficient information to the auditee and federal agency (or pass-through entity, in the case of a subrecipient) to permit them to determine the cause and effect, to facilitate prompt and proper corrective action.

g. Recommendations to prevent future occurrences of the deficiency identified in the audit finding.

h. To the extent practical, the views of responsible officials of the auditee when there is disagreement with the audit findings. If the auditee's corrective action plan is available and contains the views of the responsible officials, the auditor can indicate in the finding that the auditee disagreed with the finding and refer to the details of the auditee's position in the corrective action plan. However, if the auditor does not agree with the auditee's position, the auditor should state his or her reasons for rejecting it.

Other Preparation Guidance

10.65 Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up. One option for assigning reference numbers is to use the last two digits of the fiscal year being audited as the first two digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 199X would be assigned reference numbers 9X-1, 9X-2, etc.

10.66 A schedule of findings and questioned costs must be issued for every single audit, regardless of whether any findings or questioned costs are noted. This is because Circular A-133 requires that one section of the schedule summarize the audit results (see paragraphs 10.55 and 10.56). In a situation in which there are no findings or questioned costs, the auditor should prepare the summary of auditor's results section of the schedule and indicate in the other required sections that no matters were reportable.

10.67 Appendix E contains an illustrative schedule of findings and questioned costs.

Summary Schedule of Prior Audit Findings and Corrective Action Plan

10.68 The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee is required to prepare a summary schedule of prior audit findings. The auditee is not required to prepare a summary schedule of prior audit findings if there are no matters reportable therein. However, to best serve the needs of federal agencies and to avoid any potential future misunderstanding or allegation of nonconformity with the requirements of Circular A-133, the auditee may consider preparing in this circumstance a summary schedule circumstance that indicates that no matters are reportable. The auditee is also required to prepare a corrective action plan for each of the current-year audit findings. The summary schedule of prior audit findings and the corrective action plan, which are both part of the reporting package, must include the reference numbers the auditor assigns to audit findings in the schedule of findings and questioned costs. This numbering (or other identification) should include the fiscal year in which the finding initially occurred.

10.69 The auditor is required to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of section 500(e) of Circular A-133 (see paragraphs 6.61 through 6.65).

10.70 The auditor has no responsibility for the corrective action plan; however, the auditor may be separately engaged by the auditee for assistance in developing appropriate corrective actions in response to audit findings. The auditor may find the auditee's corrective action plan useful in performing follow-up on prior audit findings (in addition to the schedule of prior audit findings), because it may provide an indication of the corrective steps planned by the auditee.

Data Collection Form

10.71 Circular A-133 requires the auditee to complete and sign certain sections of a data collection form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. This form is not part of the reporting package (see paragraph 10.7). The information required to be included in the form, however, represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.

10.72 The auditor is also required to complete certain sections of the form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor is also required to sign a statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the date of the audit reports. This wording alleviates the auditor from any subsequent-event responsibility with regard to the timing of the completion of the form and the completion of the audit. The form includes detailed instructions, which should be carefully followed by the auditor.

10.73 The data collection form and related instructions are available on the OMB's home page at www.whitehouse.gov/WH/EOP/OMB/Grants (note that this address is "case sensitive," that is, upper- and lowercase letters must be as shown). A copy of the form and instructions can also be obtained from the Federal Audit Clearinghouse at (888) 222-9907. The form number is SF-SAC.[26]

Submission of Reporting Package and Data Collection Form

10.74 The submission of the data collection form and the reporting package, including the audit reports, is the responsibility of the auditee. The data collection form and the reporting package must be submitted by the auditee within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. However, it should be noted that Circular A-133 includes a delayed implementation date for report-submission deadlines. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and reporting package must be submitted within thirty days after the receipt of the auditor's reports, or thirteen months after the end of the audit period.

Submission to Clearinghouse

10.75 All auditees must submit to the federal clearinghouse designated by the OMB the data collection form and one copy of the reporting package (see paragraph 10.6 for a description) for (*a*) the federal clearinghouse to retain as an archival copy and (*b*) each federal awarding agency, when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the federal awarding agency provided directly or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the federal awarding agency provided directly.

Submission by Subrecipients

10.76 In addition to the requirements in paragraph 10.75, auditees that are also subrecipients must submit to each pass-through entity one copy of the reporting package for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the pass-through entity provided or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the pass-through entity provided. When a subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient must instead provide written notification to the pass-through entity that—

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[26] As of the issuance of this SOP, the Federal Audit Clearinghouse is developing the data collection form in various word processing packages, as well as a process for electronic submission. Auditors can review the Federal Audit Clearinghouse home page at http://harvester.census.gov/sac for the most current information on these developments.

- An audit of the subrecipient was conducted in accordance with Circular A-133 (including the period covered by the audit and the name, amount, and CFDA number of the federal awards provided by the pass-through entity).
- The schedule of findings and questioned costs disclosed no audit findings relating to the federal awards that the pass-through entity provided.
- The summary schedule of prior audit findings did not report on the status of any audit findings relating to the federal awards that the pass-through entity provided.

A subrecipient may submit a copy of the reporting package to a pass-through entity to comply with this notification.

Requests for Copies

10.77 In response to a request by a federal agency or pass-through entity, auditees should submit the appropriate copies of the reporting package and, if requested, a copy of any management letters issued by the auditor.

Report Retention Requirements

10.78 Auditees are required to keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse designated by the OMB. Pass-through entities should keep subrecipients' submissions on file for three years from the date of receipt.

Clearinghouse Address

10.79 The name and address of the federal clearinghouse currently designated by the OMB are as follows: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th St., Jeffersonville, IN 47132.

Freedom of Information Act

10.80 In accordance with the principles of the Freedom of Information Act (U.S. Code title 5, section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that the information contained in them is not subject to exemptions of the act that the cognizant agency for audit chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

Chapter 11

PROGRAM-SPECIFIC AUDITS

11.1 A program-specific audit is an audit of an individual federal program (rather than a single audit of an entity's financial statements and federal programs). Section 235 of Circular A-133 provides guidance on program-specific audits.

Use of a Program-Specific Audit to Satisfy Circular A-133 Audit Requirements

11.2 Circular A-133 states that when an auditee expends federal awards under only one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit performed in accordance with section 235 of the circular.[1] Therefore, the auditor should determine whether there is a financial statement audit requirement before performing a program-specific audit. A program-specific audit may not be elected for research and development unless all federal awards expended were received from the same federal agency (or the same federal agency and the same pass-through entity) and that federal agency (or pass-through entity, in the case of a subrecipient) approves a program-specific audit in advance.

Program-Specific Audit Requirements

11.3 Circular A-133 requires program-specific audits to be subject to the following sections of Circular A-133 as they may apply to program-specific audits, unless contrary to the provisions of section 235 of Circular A-133, a federal program-specific audit guide, or the program's laws and regulations:

- Purpose; definitions; audit requirements; basis for determining the federal awards expended; subrecipient and vendor determinations; relation to other audit requirements (sections 100 through 215(b))
- Frequency of audits; sanctions; audit costs (sections 220 through 230)
- Auditee responsibilities; auditor selection (sections 300 through 305)
- Follow-up on audit findings (section 315)
- Submission of report (sections 320(f) through 320(j))
- Responsibilities of federal agencies and pass-through entities; management decisions (sections 400 through 405)
- Audit findings and audit working papers (sections 510 through 515)

Program-specific audits are also subject to other provisions, referred to in section 235 of the circular.

[1] An example of a situation where a program-specific audit would not be allowed would be a not-for-profit college that receives SFA (and no other federal awards). This is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit.

Availability of Program-Specific Audit Guides

11.4 In many cases, a federal agency's Office of Inspector General will have issued a program-specific audit guide that provides guidance on internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for a particular federal program. The auditor should contact the Office of Inspector General of the federal agency to determine whether such a guide is available and current. When a current program-specific audit guide is available, the auditor should follow *Government Auditing Standards* and the guide when performing a program-specific audit. However, if there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated with regard to the changes, the auditor should follow section 235 of Circular A-133 and the *Compliance Supplement* in lieu of an outdated guide. If a guide is current with regard to a program's compliance requirements but has not been updated to conform to current authoritative standards and guidance (such as current revisions of GAAS or *Government Auditing Standards*), the auditor should follow current applicable professional standards and guidance in lieu of the outdated or inconsistent standards and guidance in the guide.

11.5 When a program-specific audit guide is not available, the auditee and the auditor have basically the same responsibilities for the federal program as they have for an audit of a major program in a single audit as discussed in chapters 6 and 8 of this SOP.

Auditee's Responsibilities When a Program-Specific Audit Guide is Not Available

11.6 In addition to having the responsibilities included in the sections of Circular A-133 that are described in paragraph 11.3, the auditee is required to prepare the following:

- The financial statements for the federal program, which include, at a minimum, a schedule of expenditures of federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule
- A summary schedule of prior audit findings consistent with the requirements of section 315(b) of Circular A-133 (see paragraphs 10.68 through 10.70)
- If applicable, a corrective action plan consistent with the requirements of section 315(c) of the circular (see paragraphs 10.68 through 10.70)

Auditor's Responsibilities When a Program-Specific Audit Guide is Not Available

Audit Scope and Requirements

11.7 Circular A-133 requires the auditor to—

- Perform an audit of the financial statement(s) for the federal program in accordance with *Government Auditing Standards* (see chapter 4 of this SOP for guidance on financial statement audits). See paragraph 11.10 for a further discussion of *Government Auditing Standards*.

- Obtain an understanding of the internal control over compliance and perform tests of the internal control over compliance for the federal program, so that they are consistent with the requirements of section 500(c) of the circular for a major program (see chapter 8 of this SOP for guidance on the internal control considerations for major programs).
- Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program consistent with the requirements of section 500(d) of the circular for a major program (see chapter 6 of this SOP for guidance on the compliance-auditing considerations for major programs).
- Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings that has been prepared by the auditee, and when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding, report this as a current-year audit finding, in accordance with the requirements of section 500(e) of the circular (see paragraphs 10.69 through 10.70).

Auditor's Reports

Circular A-133 Requirements

11.8 Circular A-133 states that the auditor's reports may be in the form of either combined or separate reports and may be organized differently from the manner described below. The auditor's reports should state that the audit was conducted in accordance with GAAS, *Government Auditing Standards*, and Circular A-133 and should include the following:

- An opinion (or disclaimer of opinion) on whether the financial statement(s) of the federal program are presented fairly in all material respects in conformity with the stated accounting policies
- A report on the internal control related to the federal program, which describes the scope of the testing of the internal control and the results of the tests
- A report on compliance, which includes an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program
- A schedule of findings and questioned costs for the federal program, which includes a summary of the auditor's results relative to the audit of the federal program in a format consistent with the requirements for the summary of auditor's results in section 505(d)(1) of the circular, as well as findings and questioned costs for federal awards consistent with the requirements of section 505(d)(3) of the circular (see paragraph 10.55 and 10.56)

Recommended Auditor's Reports

11.9 In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a program-specific audit (*a*) an opinion on the financial statement(s) of the federal program and (*b*) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under OMB Circular A-133. See the following paragraph for a discussion of the possible issuance of a third report to meet the reporting requirements of *Government Auditing Standards*. Illustrations of program-specific audit reports are included in examples 6 and 6a of appendix D.

Reporting in Accordance With Government Auditing Standards

11.10 If the financial statement(s) of the program only present the activity of the federal program, the auditor is not required to issue a separate report to meet the reporting requirements of *Government Auditing Standards*. This is because, in many cases, by definition the financial statements of the program consist only of the schedule of expenditures of federal awards. In this situation, examples 6 and 6a of appendix D, would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133. However, it should be noted that the auditor always has the option of issuing a separate *Government Auditing Standards* report (in addition to the two reports described in paragraph 11.9). Although it is not as common, the financial statement(s) of the federal program may present more than the program's activity (for example, a municipal sewer district issues financial statements that include both normal operations and the federal program activity related to a grant for the purpose of building a new sewage-treatment facility). In this situation, the auditor should issue a separate *Government Auditing Standards* report (example 2 or 2a of appendix D), and modify it so that it refers only to the financial statement(s) of the federal program.

Submission of Report

Timing of Submission

11.11 Circular A-133 requires the audit to be completed and the reporting required by sections 235(c)(2) and 235(c)(3) of the circular to be submitted, within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the federal agency that provided the funding or unless a different period is specified in a program-specific audit guide.[2] Unless restricted by law or regulation, Circular A-133 requires the auditee to make copies of the report available for public inspection.

Submission When a Program-Specific Audit Guide is Available

11.12 When a program-specific audit guide is available, the auditee must submit to the federal clearinghouse designated by the OMB (see paragraph 10.79) the data collection form prepared in accordance with section 320(b) of the Circular (see paragraphs 10.71 through 10.73), as applicable for a program-specific audit, and must also submit the reporting that is required by the pro-

[2] It should be noted that Circular A-133 includes a delayed implementation date for deadlines for the submission of reports. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the required reports submitted within the earlier of thirty days after the receipt of the auditor's report or thirteen months after the end of the audit period.

gram-specific audit guide which is to be retained as an archival copy. The auditee must also submit to the federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

Submission When a Program-Specific Audit Guide is Not Available

11.13 When a program-specific audit guide is not available, the reporting package for a program-specific audit consists of the following:

- The financial statement(s) of the federal program
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70)
- A corrective action plan (see paragraphs 10.68 through 10.70)
- The auditor's report(s) described in paragraphs 11.8 through 11.10

11.14 The data collection form, as applicable to a program-specific audit, and one copy of the reporting package must be submitted to the federal clearinghouse designated by the OMB (see paragraph 10.79), to be retained as an archival copy. Furthermore, when the schedule of findings and questioned costs discloses audit findings or the summary schedule of prior audit findings reports the status of any audit findings, the auditee must submit one copy of the reporting package to the federal clearinghouse on behalf of the federal awarding agency or, in the case of a subrecipient, directly to the pass-through entity. When a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient is instead required to provide written notification to the pass-through entity, consistent with the requirements of section 320(e)(2) of Circular A-133 (see paragraph 10.76). A subrecipient may submit a copy of the reporting package to the pass-through entity, to comply with the notification requirement.

APPENDIX A

Single Audit Act Amendments of 1996

Public Law 104-156
104th Congress

An Act

July 5, 1996
[S. 1579]

To streamline and improve the effectiveness of chapter 75 of title 31, United States Code (commonly referred to as the "Single Audit Act").

Single Audit Act Amendments of 1996.
31 USC 7501 note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; PURPOSES.

(a) SHORT TITLE—This Act may be cited as the "Single Audit Act Amendments of 1996".

(b) PURPOSES—The purposes of this Act are to—

(1) promote sound financial management, including effective internal controls, with respect to Federal awards administered by non-Federal entities;

(2) establish uniform requirements for audits of Federal awards administered by non-Federal entities;

(3) promote the efficient and effective use of audit resources;

(4) reduce burdens on State and local governments, Indian tribes, and nonprofit organizations; and

(5) ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as amended by this Act).

SEC. 2. AMENDMENT TO TITLE 31, UNITED STATES CODE.

Chapter 75 of title 31, United States Code, is amended to read as follows:

"CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS

"Sec.
"7501. Definitions.
"7502. Audit requirements; exemptions.
"7503. Relation to other audit requirements.
"7504. Federal agency responsibilities and relations with non-Federal entities.
"7505. Regulations.
"7506. Monitoring responsibilities of the Comptroller General.
"7507. Effective date.

"§ 7501. Definitions

"(a) As used in this chapter, the term—

"(1) 'Comptroller General' means the Comptroller General of the United States;

"(2) 'Director' means the Director of the Office of Management and Budget;

"(3) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5;

"(4) "Federal awards' means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities;

"(5) 'Federal financial assistance' means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director;

"(6) 'Federal program' means all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance or encompassed in a group of numbers or other category as defined by the Director;

"(7) 'generally accepted government auditing standards' means the government auditing standards issued by the Comptroller General;

"(8) 'independent auditor' means—

"(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards; or

"(B) a public accountant who meets such independence standards;

"(9) 'Indian tribe' means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians;

"(10) 'internal controls' means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

"(A) Effectiveness and efficiency of operations.

"(B) Reliability of financial reporting.

"(C) Compliance with applicable laws and regulations;

"(11) 'local government' means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, any other instrumentality of local government and, in accordance with guidelines issued by the Director, a group of local governments;

"(12) 'major program' means a Federal program identified in accordance with risk-based criteria prescribed by the Director under this chapter, subject to the limitations described under subsection (b);

"(13) 'non-Federal entity' means a State, local government, or nonprofit organization;

"(14) 'nonprofit organization' means any corporation, trust, association, cooperative, or other organization that—

"(A) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

"(B) is not organized primarily for profit; and

"(C) uses net proceeds to maintain, improve, or expand the operations of the organization;

"(15) 'pass-through entity' means a non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program;

"(16) 'program-specific audit' means an audit of one Federal program;

"(17) 'recipient' means a non-Federal entity that receives awards directly from a Federal agency to carry out a Federal program;

"(18) 'single audit' means an audit, as described under section 7502(d), of a non-Federal entity that includes the entity's financial statements and Federal awards;

"(19) 'State' means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe; and

"(20) 'subrecipient' means a non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.

"(b) In prescribing risk-based program selection criteria for major programs, the Director shall not require more programs to be identified as major for a particular non-Federal entity, except as prescribed under subsection (c) or as provided under subsection (d), than would be identified if the major programs were defined as any program for which total expenditures of Federal awards by the non-Federal entity during the applicable year exceed—

"(1) the larger of $30,000,000 or 0.15 percent of the non-Federal entity's total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed $10,000,000,000;

"(2) the larger of $3,000,000, or 0.30 percent of the non-Federal entity's total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed $100,000,000 but are less than or equal to $10,000,000,000; or

"(3) the larger of $300,000, or 3 percent of such total Federal expenditures for all programs, in the case of a non-Federal entity for which such total expenditures for all programs equal or exceed $300,000 but are less than or equal to $100,000,000.

"(c) When the total expenditures of a non-Federal entity's major programs are less than 50 percent of the non-Federal entity's total expenditures of all Federal awards (or such lower percentage as specified by the Director), the auditor shall select and test additional programs as major programs as necessary to achieve audit coverage of at least 50 percent of Federal expenditures by the non-Federal entity (or such lower percentage as specified by the Director), in accordance with guidance issued by the Director.

"(d) Loan or loan guarantee programs, as specified by the Director, shall not be subject to the application of subsection (b).

"§ 7502. Audit requirements; exemptions

"(a)(1)(A) Each non-Federal entity that expends a total amount of Federal awards equal to or in excess of $300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such non-Federal entity shall have either a single audit or a program-specific audit made for such fiscal year in accordance with the requirements of this chapter.

"(B) Each such non-Federal entity that expends Federal awards under more than one Federal program shall undergo a single audit in accordance with the requirements of subsections (b) through (i) of this section and guidance issued by the Director under section 7505.

"(C) Each such non-Federal entity that expends awards under only one Federal program and is not subject to laws, regulations, or Federal award agreements that require a financial statement audit of the non-Federal entity, may elect to have a program-specific audit conducted in accordance with applicable provisions of this section and guidance issued by the Director under section 7505.

"(2)(A) Each non-Federal entity that expends a total amount of Federal awards of less than $300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such entity, shall be exempt for such fiscal year from compliance with—

"(i) the audit requirements of this chapter; and

"(ii) any applicable requirements concerning financial audits contained in Federal statutes and regulations governing programs under which such Federal awards are provided to that non-Federal entity.

"(B) The provisions of subparagraph (A)(ii) of this paragraph shall not exempt a non-Federal entity from compliance with any provision of a Federal statute or regulation that requires such non-Federal entity to maintain records concerning Federal awards provided to such non-Federal entity or that permits a Federal agency, pass-through entity, or the Comptroller General access to such records.

"(3) Every 2 years, the Director shall review the amount for requiring audits prescribed under paragraph (1)(A) and may adjust such dollar amount consistent with the purposes of this chapter, provided the Director does not make such adjustments below $300,000.

"(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

"(2) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

"(3) Any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

"(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally accepted government auditing standards, except that, for the purposes of this chapter, performance audits shall not be required except as authorized by the Director.

"(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall—

"(1) cover the operations of the entire non-Federal entity; or

"(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

"(e) The auditor shall—

"(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

"(2) determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

"(3) with respect to internal controls pertaining to the compliance requirements for each major program—

"(A) obtain an understanding of such internal controls;

"(B) assess control risk; and

"(C) perform tests of controls unless the controls are deemed to be ineffective; and

"(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

"(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

"(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

"(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

"(2) Each pass-through entity shall—

"(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

"(B) monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

"(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

"(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

"(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director. Reports.

"(2) When reporting on any single audit, the auditor shall include a summary of the auditor's results regarding the non-Federal entity's financial statements, internal controls, and compliance with laws and regulations.

"(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity's financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor's reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of—

"(1) 30 days after receipt of the auditor's report; or

"(2)(A) for a transition period of at least 2 years after the effective date of the Single Audit Act Amendments of 1996, as established by the Director, 13 months after the end of the period audited; or

"(B) for fiscal years beginning after the period specified in subparagraph (A), 9 months after the end of the period audited, or within a longer time frame authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month time frame would place an undue burden on the non-Federal entity.

"(i) If an audit conducted pursuant to this section discloses any audit findings, as defined by the Director, including material noncompliance with individual compliance requirements for a major program by, or reportable conditions in the internal controls of, the non-Federal entity with respect to the matters described in subsection (e), the non-Federal entity shall submit to Federal officials designated by the Director, a plan for corrective action to eliminate such audit findings or reportable conditions or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(c).

"(j) The Director may authorize pilot projects to test alternative methods of achieving the purposes of this chapter. Such pilot projects may begin only after consultation with the Chair and Ranking Minority Member of the Committee on Governmental Affairs of the Senate and the Chair and Ranking Minority Member of the Committee on Government Reform and Oversight of the House of Representatives.

§ 7503. Relation to other audit requirements

"(a) An audit conducted in accordance with this chapter shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal law or regulation, a Federal agency shall rely upon and use that information.

"(b) Notwithstanding subsection (a), a Federal agency may conduct or arrange for additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any non-Federal entity (or subrecipient thereof) to constrain, in any manner, such agency from carrying out or arranging for such additional audits, except that the Federal agency shall plan such audits to not be duplicative of other audits of Federal awards.

"(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or arrange for the conduct of, audits and evaluations of Federal awards, nor limit the authority of any Federal agency Inspector General or other Federal official.

"(d) Subsection (a) shall apply to a non-Federal entity which undergoes an audit in accordance with this chapter even though it is not required by section 7502(a) to have such an audit.

"(e) A Federal agency that provides Federal awards and conducts or arranges for audits of non-Federal entities receiving such awards that are in addition to the audits of non-Federal entities conducted pursuant to this chapter shall, consistent with other applicable law, arrange for funding the full cost of such additional audits. Any such additional audits shall be coordinated with the Federal agency determined under criteria issued under section 7504 to preclude duplication of the audits conducted pursuant to this chapter or other additional audits.

"(f) Upon request by a Federal agency or the Comptroller General, any independent auditor conducting an audit pursuant to this chapter shall make the auditor's working papers available to the Federal agency or the Comptroller General as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this chapter. Such access to auditor's working papers shall include the right to obtain copies.

"§ 7504. Federal agency responsibilities and relations with non-Federal entities

"(a) Each Federal agency shall, in accordance with guidance issued by the Director under section 7505, with regard to Federal awards provided by the agency—

"(1) monitor non-Federal entity use of Federal awards, and

"(2) assess the quality of audits conducted under this chapter for audits of entities for which the agency is the single Federal agency determined under subsection (b).

"(b) Each non-Federal entity shall have a single Federal agency, determined in accordance with criteria established by the Director, to provide the non-Federal entity with technical assistance and assist with implementation of this chapter.

"(c) The Director shall designate a Federal clearinghouse to—

"(1) receive copies of all reporting packages developed in accordance with this chapter;

"(2) identify recipients that expend $300,000 or more in Federal awards or such other amount specified by the Director under section 7502(a)(3) during the recipient's fiscal year but did not undergo an audit in accordance with this chapter; and

"(3) perform analyses to assist the Director in carrying out responsibilities under this chapter.

"§ 7505. Regulations

"(a) The Director, after consultation with the Comptroller General, and appropriate officials from Federal, State, and local governments and nonprofit organizations shall prescribe guidance to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such guidance.

"(b)(1) The guidance prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to Federal awards for the cost of audits. Such criteria shall prohibit a non-Federal entity from charging to any Federal awards—

"(A) the cost of any audit which is—

"(i) not conducted in accordance with this chapter; or

"(ii) conducted in accordance with this chapter when expenditures of Federal awards are less than amounts cited in section 7502(a)(1)(A) or specified by the Director under section 7502(a)(3), except that the Director may allow the cost of limited scope audits to monitor subrecipients in accordance with section 7502(f)(2)(B); and

"(B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

"(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit the percentage of the cost of audits performed pursuant to this chapter charged to Federal awards, to exceed the ratio of total Federal awards expended by such non-Federal entity during the applicable fiscal year or years, to such non-Federal entity's total expenditures during such fiscal year or years.

"(c) Such guidance shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

"§ 7506. Monitoring responsibilities of the Comptroller General

"(a) The Comptroller General shall review provisions requiring financial audits of non-Federal entities that receive Federal awards that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives.

"(b) If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

"(1) the committee that reported such bill or resolution; and

"(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

"(B) the Committee on Government Reform and Oversight of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

"§ 7507. Effective date

"This chapter shall apply to any non-Federal entity with respect to any of its fiscal years which begin after June 30, 1996.".

31 USC 7501 note.

SEC. 3. TRANSITIONAL APPLICATION

Subject to section 7507 of title 31, United States Code (as amended by section 2 of this Act) the provisions of chapter 75 of such title (before amendment by section 2 of this Act) shall continue to apply to any State or local government with respect to any of its fiscal years beginning before July 1, 1996.

Approved July 5, 1996.

LEGISLATIVE HISTORY—S. 1579 (H.R. 3184):

HOUSE REPORTS: No. 104–607 accompanying H.R. 3184 (Comm. on Government Reform and Oversight).

SENATE REPORTS: No. 104–266 (Comm. On Governmental Affairs).

CONGRESSIONAL RECORD, Vol. 142 (1996):
June 14, considered and passed Senate.
June 18, considered and passed House.

WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 32 (1996):
July 5, Presidential statement.

APPENDIX B

OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

Franklin D. Raines,
Director

1. OMB rescinds Circular A-128 July 30, 1997

2. OMB revises Circular A-133 to read as follows:

[Circular No. A-133—Revised]

To the Heads of Executive Departments and Establishments

SUBJECT: Audits of States, Local Governments, and Non-Profit Organizations.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. It sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of States, local governments, and non-profit organizations expending Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of sections 503, 1111, and 7501 *et seq.* of title 31, United States Code, and Executive Orders 8248 and 11541.

3. *Rescission and Supersession.* This Circular rescinds Circular A-128, "Audits of State and Local Governments," issued April 12, 1985, and supersedes the prior Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," issued April 22, 1996. For effective dates, see paragraph 10.

4. *Policy.* Except as provided herein, the standards set forth in this Circular shall be applied by all Federal agencies. If any statute specifically prescribes policies or specific requirements that differ from the standards provided herein, the provisions of the subsequent statute shall govern.

Federal agencies shall apply the provisions of the sections of this Circular to non-Federal entities, whether they are recipients expending Federal awards received directly from Federal awarding agencies, or are subrecipients expending Federal awards received from a pass-through entity (a recipient or another subrecipient).

This Circular does not apply to non-U.S. based entities expending Federal awards received either directly as a recipient or indirectly as a subrecipient.

5. *Definitions.* The definitions of key terms used in this Circular are contained in §___.105 in the Attachment to this Circular.

6. *Required Action.* The specific requirements and responsibilities of Federal agencies and non-Federal entities are set forth in the Attachment to this

Circular. Federal agencies making awards to non-Federal entities, either directly or indirectly, shall adopt the language in the Circular in codified regulations as provided in Section 10 (below), unless different provisions are required by Federal statute or are approved by the Office of Management and Budget (OMB).

7. *OMB Responsibilities.* OMB will review Federal agency regulations and implementation of this Circular, and will provide interpretations of policy requirements and assistance to ensure uniform, effective and efficient implementation.

8. *Information Contact.* Further information concerning Circular A-133 may be obtained by contacting the Financial Standards and Reporting Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, telephone (202) 395-3993.

9. *Review Date.* This Circular will have a policy review three years from the date of issuance.

10. *Effective Dates.* The standards set forth in §___.400 of the Attachment to this Circular, which apply directly to Federal agencies, shall be effective July 1, 1996, and shall apply to audits of fiscal years beginning after June 30, 1996, except as otherwise specified in §___.400(a).

The standards set forth in this Circular that Federal agencies shall apply to non-Federal entities shall be adopted by Federal agencies in codified regulations not later than 60 days after publication of this final revision in the **Federal Register**, so that they will apply to audits of fiscal years beginning after June 30, 1996, with the exception that §___.305(b) of the Attachment applies to audits of fiscal years beginning after June 30, 1998. The requirements of Circular A-128, although the Circular is rescinded, and the 1990 version of Circular A-133 remain in effect for audits of fiscal years beginning on or before June 30, 1996.

Franklin D. Raines,
Director.

Attachment

PART___—AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS

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Appendix A to Part___—Data Collection Form (Form SF-SAC)

Appendix B to Part___—Circular A-133 Compliance Supplement

Subpart A—General

§___.100 Purpose.

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

§___.105 Definitions.

Auditee means any non-Federal entity that expends Federal awards which must be audited under this part.

Auditor means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of non-profit organizations.

Audit finding means deficiencies which the auditor is required by §___.510(a) to report in the schedule of findings and questioned costs.

CFDA number means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance (CFDA).*

Cluster of programs means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with §___.400(d)(1) and §___.400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in §___.520, and, with the exception of R&D as described in §___.200(c), whether a program-specific audit may be elected.

Cognizant agency for audit means the Federal agency designated to carry out the responsibilities described in §___.400(a).

Compliance supplement refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it. This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

Corrective action means action taken by the auditee that:

(1) Corrects identified deficiencies;

(2) Produces recommended improvements; or

(3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

Federal agency has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

Federal award means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCOs) are excluded from the requirements of this part.

Federal awarding agency means the Federal agency that provides an award directly to the recipient.

Federal financial assistance means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in §___.205(h) and §___.205(i).

Federal program means:

(1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.

(2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.

(3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:

(i) Research and development (R&D);

(ii) Student financial aid (SFA); and

(iii) "Other clusters," as described in the definition of cluster of programs in this section.

GAGAS means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

Generally accepted accounting principles has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

Indian tribe means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

Internal control means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

(1) Effectiveness and efficiency of operations;

(2) Reliability of financial reporting; and

(3) Compliance with applicable laws and regulations.

Internal control pertaining to the compliance requirements for Federal programs (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

(1) Transactions are properly recorded and accounted for to:

(i) Permit the preparation of reliable financial statements and Federal reports;

(ii) Maintain accountability over assets; and

(iii) Demonstrate compliance with laws, regulations, and other compliance requirements;

(2) Transactions are executed in compliance with:

(i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and

(ii) Any other laws and regulations that are identified in the compliance supplement; and

(3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Loan means a Federal loan or loan guarantee received or administered by a non-Federal entity.

Local government means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Major program means a Federal program determined by the auditor to be a major program in accordance with §___.520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with §___.215(c).

Management decision means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

Non-Federal entity means a State, local government, or non-profit organization.

Non-profit organization means:

(1) any corporation, trust, association, cooperative, or other organization that:

(i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

(ii) Is not organized primarily for profit; and

(iii) Uses its net proceeds to maintain, improve, or expand its operations; and

(2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

OMB means the Executive Office of the President, Office of Management and Budget.

Oversight agency for audit means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in §___.400(b).

Pass-through entity means a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

Program-specific audit means an audit of one Federal program as provided for in §___.200(c) and §___.235.

Questioned cost means a cost that is questioned by the auditor because of an audit finding:

(1) Which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds;

(2) Where the costs, at the time of the audit, are not supported by adequate documentation; or

(3) Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Recipient means a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

Research and development (R&D) means all research activities, both basic and applied, and all development activities that are performed by a non-Federal entity. *Research* is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. The term research also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other research and development activities and where such activities are not included in the instruction function. *Development* is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

Single audit means an audit which includes both the entity's financial statements and the Federal awards as described in §___.500.

State means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe as defined in this section.

Student Financial Aid (SFA) includes those programs of general student assistance, such as those authorized by Title IV of the Higher Education Act of 1965, as amended, (20 U.S.C. 1070 *et seq.*) which is administered by the U.S. Department of Education, and similar programs provided by other Federal agencies. It does not include programs which provide fellowships or similar Federal awards to students on a competitive basis, or for specified studies or research.

Subrecipient means a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency. Guidance on distinguishing between a subrecipient and a vendor is provided in §___.210.

Types of compliance requirements refers to the types of compliance requirements listed in the compliance supplement. Examples include: activities allowed or unallowed; allowable costs/cost principles; cash management; eligibility; matching, level of effort, earmarking; and, reporting.

Vendor means a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a Federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the Federal program. Additional guidance on distinguishing between a subrecipient and a vendor is provided in §___.210.

Subpart B—Audits

§___.200 Audit requirements.

(a) *Audit required.* Non-Federal entities that expend $300,000 or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in §___.205.

(b) *Single audit.* Non-Federal entities that expend $300,000 or more in a year in Federal awards shall have a single audit conducted in accordance with §___.500 except when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

(c) *Program-specific audit election.* When an auditee expends Federal awards under only one Federal program (excluding R&D) and the Federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit conducted in accordance with §___.235. A program-specific audit may not be elected for R&D unless all of the Federal awards expended were received from the same Federal agency, or the same Federal agency and the same pass-through entity, and that Federal agency, or pass-through entity in the case of a subrecipient, approves in advance a program-specific audit.

(d) *Exemption when Federal awards expended are less than $300,000.* Non-Federal entities that expend less than $300,000 a year in Federal awards are exempt from Federal audit requirements for that year, except as noted in §___.215(a), but records must be available for review or audit by appropriate officials of the Federal agency, pass-through entity, and General Accounting Office (GAO).

(e) *Federally Funded Research and Development Centers* (FFRDC). Management of an auditee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

§___.205 Basis for determining Federal awards expended.

(a) *Determining Federal awards expended.* The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.

(b) *Loan and loan guarantees (loans).* Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:

(1) Value of new loans made or received during the fiscal year; plus

(2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus

(3) Any interest subsidy, cash, or administrative cost allowance received.

(c) *Loan and loan guarantees (loans) at institutions of higher education.* When loans are made to students of an institution of higher education but the institution does not make the loans, then only the value of loans made during the year shall be considered Federal awards expended in that year. The balance of loans for previous years is not included as Federal awards expended because the lender accounts for the prior balances.

(d) *Prior loan and loan guarantees (loans).* Loans, the proceeds of which were received and expended in prior-years, are not considered Federal awards expended under this part when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

(e) *Endowment funds.* The cumulative balance of Federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

(f) *Free rent.* Free rent received by itself is not considered a Federal award expended under this part. However, free rent received as part of an award to carry out a Federal program shall be included in determining Federal awards expended and subject to audit under this part.

(g) *Valuing non-cash assistance.* Federal non-cash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property, shall be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

(h) *Medicare.* Medicare payments to a non-Federal entity for providing patient care services to Medicare eligible individuals are not considered Federal awards expended under this part.

(i) *Medicaid.* Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered Federal awards expended under this part unless a State requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis.

(j) *Certain loans provided by the National Credit Union Administration.* For purposes of this part, loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured institutions are not considered Federal awards expended.

§___.210 Subrecipient and vendor determinations.

(a) *General.* An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. The payments received for goods or services provided as a vendor would not be considered Federal awards. The guidance in paragraphs (b) and (c) of this section should be considered in determining whether payments constitute a Federal award or a payment for goods and services.

(b) *Federal award.* Characteristics indicative of a Federal award received by a subrecipient are when the organization:

(1) Determines who is eligible to receive what Federal financial assistance;

(2) Has its performance measured against whether the objectives of the Federal program are met;

(3) Has responsibility for programmatic decision making;

(4) Has responsibility for adherence to applicable Federal program compliance requirements; and

(5) Uses the Federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) *Payment for goods and services.* Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

(1) Provides the goods and services within normal business operations;

(2) Provides similar goods or services to many different purchasers;

(3) Operates in a competitive environment;

(4) Provides goods or services that are ancillary to the operation of the Federal program; and

(5) Is not subject to compliance requirements of the Federal program.

(d) *Use of judgment in making determination.* There may be unusual circumstances or exceptions to the listed characteristics. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present and judgment should be used in determining whether an entity is a subrecipient or vendor.

(e) *For-profit subrecipient.* Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.

(f) *Compliance responsibility for vendors.* In most cases, the auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. Program compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions which are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance. Also, when these vendor transactions relate to a major program, the scope of the audit shall include determining whether these transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements.

§___.215 Relation to other audit requirements.

(a) *Audit under this part in lieu of other audits.* An audit made in accordance with this part shall be in lieu of any financial audit required under individual

Federal awards. To the extent this audit meets a Federal agency's needs, it shall rely upon and use such audits. The provisions of this part neither limit the authority of Federal agencies, including their Inspectors General, or GAO to conduct or arrange for additional audits (e.g., financial audits, performance audits, evaluations, inspections, or reviews) nor authorize any auditee to constrain Federal agencies from carrying out additional audits. Any additional audits shall be planned and performed in such a way as to build upon work performed by other auditors.

(b) *Federal agency to pay for additional audits.* A Federal agency that conducts or contracts for additional audits shall, consistent with other applicable laws and regulations, arrange for funding the full cost of such additional audits.

(c) *Request for a program to be audited as a major program.* A Federal agency may request an auditee to have a particular Federal program audited as a major program in lieu of the Federal agency conducting or arranging for the additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such request by informing the Federal agency whether the program would otherwise be audited as a major program using the risk-based audit approach described in §___.520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this Federal agency request, and the Federal agency agrees to pay the full incremental costs, then the auditee shall have the program audited as a major program. A pass-through entity may use the provisions of this paragraph for a subrecipient.

§___.220 Frequency of audits.

Except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period.

(a) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period under audit.

(b) Any non-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this part biennially.

§___.225 Sanctions.

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

(a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;

(b) Withholding or disallowing overhead costs;

(c) Suspending Federal awards until the audit is conducted; or

(d) Terminating the Federal award.

§___.230 **Audit costs.**

(a) *Allowable costs.* Unless prohibited by law, the cost of audits made in accordance with the provisions of this part are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (FAR) (48 CFR parts 30 and 31), or other applicable cost principles or regulations.

(b) *Unallowable costs.* A non-Federal entity shall not charge the following to a Federal award:

(1) The cost of any audit under the Single Audit Act Amendments of 1996 (31 U.S.C. 7501 *et seq.*) not conducted in accordance with this part.

(2) The cost of auditing a non-Federal entity which has Federal awards expended of less than $300,000 per year and is thereby exempted under §___.200(d) from having an audit conducted under this part. However, this does not prohibit a pass-through entity from charging Federal awards for the cost of limited scope audits to monitor its subrecipients in accordance with §___.400(d)(3), provided the subrecipient does not have a single audit. For purposes of this part, limited scope audits only include agreed-upon procedures engagements conducted in accordance with either the AICPA's generally accepted auditing standards or attestation standards, that are paid for and arranged by a pass-through entity and address only one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and, reporting.

§___.235 **Program-specific audits.**

(a) *Program-specific audit guide available.* In many cases, a program-specific audit guide will be available to provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. The auditor should contact the Office of Inspector General of the Federal agency to determine whether such a guide is available. When a current program-specific audit guide is available, the auditor shall follow GAGAS and the guide when performing a program-specific audit.

(b) *Program-specific audit guide not available.* (1) When a program-specific audit guide is not available, the auditee and auditor shall have basically the same responsibilities for the Federal program as they would have for an audit of a major program in a single audit.

(2) The auditee shall prepare the financial statement(s) for the Federal program that includes, at a minimum, a schedule of expenditures of Federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule, a summary schedule of prior audit findings consistent with the requirements of §___.315(b), and a corrective action plan consistent with the requirements of §___.315(c).

(3) The auditor shall:

(i) Perform an audit of the financial statement(s) for the Federal program in accordance with GAGAS;

(ii) Obtain an understanding of internal control and perform tests of internal control over the Federal program consistent with the requirements of §___.500(c) for a major program;

(iii) Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the Federal program consistent with the requirements of §___.500(d) for a major program; and

(iv) Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of §___.500(e).

(4) The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

(i) An opinion (or disclaimer of opinion) as to whether the financial statement(s) of the Federal program is presented fairly in all material respects in conformity with the stated accounting policies;

(ii) A report on internal control related to the Federal program, which shall describe the scope of testing of internal control and the results of the tests;

(iii) A report on compliance which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on the Federal program; and

(iv) A schedule of findings and questioned costs for the Federal program that includes a summary of the auditor's results relative to the Federal program in a format consistent with §___.505(d)(1) and findings and questioned costs consistent with the requirements of §___.505(d)(3).

(c) *Report submission for program-specific audits.* (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.

(2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data

collection form prepared in accordance with §___.320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

(3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with §___.320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of §___.320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) *Other sections of this part may apply.* Program-specific audits are subject to §___.100 through §___.215(b), §___.220 through §___.230, §___.300 through §___.305, §___.315, §___.320(f) through §___.320(j), §___.400 through §___.405, §___.510 through §___.515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

Subpart C—Auditees

§___.300 Auditee responsibilities.

The auditee shall:

(a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.

(b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.

(c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

(d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with §___.310.

(e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by §___.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.

(f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with §___.315(b) and §___.315(c), respectively.

§___.305 Auditor selection.

(a) *Auditor procurement.* In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the "A-102 Common Rule") published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations," or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) *Restriction on auditor preparing indirect cost proposals.* An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded $1 million. This restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

§___.310 Financial statements.

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with §___.500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

(1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.

(2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.

(3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other identifying number when the CFDA information is not available.

(4) Include notes that describe the significant accounting policies used in preparing the schedule.

(5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.

(6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

§___.315 Audit findings follow-up.

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under §___.510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

(1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.

(2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.

(3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.

(4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:

(i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;

(ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and

(iii) A management decision was not issued.

(c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

§___.320 Report submission.

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.* (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.

(2) The data collection form shall include the following data elements:

(i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).

(ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.

(iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.

(iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.

(v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).

(vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to §___.320(d)(2).

(vii) A yes or no statement as to whether the auditee qualified as a low-risk auditee under §___.530.

(viii) The dollar threshold used to distinguish between Type A and Type B programs as defined in §___.520(b).

(ix) The *Catalog of Federal Domestic Assistance* (CFDA) number for each Federal program, as applicable.

(x) The name of each Federal program and identification of each major program. Individual programs within a cluster of programs should be listed in the same level of detail as they are listed in the schedule of expenditures of Federal awards.

(xi) The amount of expenditures in the schedule of expenditures of Federal awards associated with each Federal program.

(xii) For each Federal program, a yes or no statement as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs:

(A) Activities allowed or unallowed.

(B) Allowable costs/cost principles.

(C) Cash management.

(D) Davis-Bacon Act.

(E) Eligibility.

(F) Equipment and real property management.

(G) Matching, level of effort, earmarking.

(H) Period of availability of Federal funds.

(I) Procurement and suspension and debarment.

(J) Program income.

(K) Real property acquisition and relocation assistance.

(L) Reporting.

(M) Subrecipient monitoring.

(N) Special tests and provisions.

(xiii) Auditee Name, Employer Identification Number(s), Name and Title of Certifying Official, Telephone Number, Signature, and Date.

(xiv) Auditor Name, Name and Title of Contact Person, Auditor Address, Auditor Telephone Number, Signature, and Date.

(xv) Whether the auditee has either a cognizant or oversight agency for audit.

(xvi) The name of the cognizant or oversight agency for audit determined in accordance with §___.400(a) and §___.400(b), respectively.

(3) Using the information included in the reporting package described in paragraph (c) of this section, the auditor shall complete the applicable sections of the form. The auditor shall sign a statement to be included as part of the data collection form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package described in paragraph (c) of this section, and that the content of the form is limited to the data elements prescribed by OMB.

(c) *Reporting package.* The reporting package shall include the:

(1) Financial statements and schedule of expenditures of Federal awards discussed in §___.310(a) and §___.310(b), respectively;

(2) Summary schedule of prior audit findings discussed in §___.315(b);

(3) Auditor's report(s) discussed in §___.505; and

(4) Corrective action plan discussed in §___.315(c).

(d) *Submission to clearinghouse.* All auditees shall submit to the Federal clearinghouse designated by OMB the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section for:

(1) The Federal clearinghouse to retain as an archival copy; and

(2) Each Federal awarding agency when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the Federal awarding agency provided directly or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the Federal awarding agency provided directly.

(e) *Additional submission by subrecipients.* (1) In addition to the requirements discussed in paragraph (d) of this section, auditees that are also subrecipients shall submit to each pass-through entity one copy of the reporting package described in paragraph (c) of this section for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the pass-through entity provided or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the pass-through entity provided.

(2) Instead of submitting the reporting package to a pass-through entity, when a subrecipient is not required to submit a reporting package to a pass-through entity pursuant to paragraph (e)(1) of this section, the subrecipient shall provide written notification to the pass-through entity that: an audit of the subrecipient was conducted in accordance with this part (including the period covered by the audit and the name, amount, and CFDA number of the Federal award(s) provided by the pass-through entity); the schedule of findings and questioned costs disclosed no audit findings relating to the Federal award(s) that the pass-through entity provided; and, the summary schedule of prior audit findings did not report on the status of any audit findings relating to the Federal award(s) that the pass-through entity provided. A subrecipient may submit a copy of the reporting package described in paragraph (c) of this section to a pass-through entity to comply with this notification requirement.

(f) *Requests for report copies.* In response to requests by a Federal agency or pass-through entity, auditees shall submit the appropriate copies of the reporting package described in paragraph (c) of this section and, if requested, a copy of any management letters issued by the auditor.

(g) *Report retention requirements.* Auditees shall keep one copy of the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section on file for three years from the date of submission to the Federal clearinghouse designated by OMB. Pass-through entities shall keep subrecipients' submissions on file for three years from date of receipt.

(h) *Clearinghouse responsibilities.* The Federal clearinghouse designated by OMB shall distribute the reporting packages received in accordance with paragraph (d)(2) of this section and §___.235(c)(3) to applicable Federal awarding agencies, maintain a data base of completed audits, provide appropriate information to Federal agencies, and follow up with known auditees which have not submitted the required data collection forms and reporting packages.

(i) *Clearinghouse address.* The address of the Federal clearinghouse currently designated by OMB is Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, IN 47132.

(j) *Electronic filing.* Nothing in this part shall preclude electronic submissions to the Federal clearinghouse in such manner as may be approved by OMB. With OMB approval, the Federal clearinghouse may pilot test methods of electronic submissions.

Subpart D—Federal Agencies and Pass-Through Entities

§___.400 Responsibilities.

(a) *Cognizant agency for audit responsibilities.* Recipients expending more than $25 million a year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizant agency for audit assignment. To provide for continuity of cognizance, the determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 1995, 2000, 2005, and every fifth year thereafter. For example, audit cognizance for periods ending in 1997 through 2000 will be determined based on Federal awards expended in 1995. (However, for States and local governments that expend more than $25 million a year in Federal awards and have previously assigned cognizant agencies for audit, the requirements of this paragraph are not effective until fiscal years beginning after June 30, 2000.) Notwithstanding the manner in which audit cognizance is determined, a Federal awarding agency with cognizance for an auditee may reassign cognizance to another Federal awarding agency which provides substantial direct funding and agrees to be the cognizant agency for audit. Within 30 days after any reassignment, both the old and the new cognizant agency for audit shall notify the auditee, and, if known, the auditor of the reassignment. The cognizant agency for audit shall:

(1) Provide technical audit advice and liaison to auditees and auditors.

(2) Consider auditee requests for extensions to the report submission due date required by §___.320(a). The cognizant agency for audit may grant extensions for good cause.

(3) Obtain or conduct quality control reviews of selected audits made by non-Federal auditors, and provide the results, when appropriate, to other interested organizations.

(4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by GAGAS or laws and regulations.

(5) Advise the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee shall work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit shall notify the auditor, the auditee, and applicable Federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance by auditors shall be referred to appropriate State licensing agencies and professional bodies for disciplinary action.

(6) Coordinate, to the extent practical, audits or reviews made by or for Federal agencies that are in addition to the audits made pursuant to this part, so that the additional audits or reviews build upon audits performed in accordance with this part.

(7) Coordinate a management decision for audit findings that affect the Federal programs of more than one agency.

(8) Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.

(9) For biennial audits permitted under §___.220, consider auditee requests to qualify as a low-risk auditee under §___.530(a).

(b) *Oversight agency for audit responsibilities.* An auditee which does not have a designated cognizant agency for audit will be under the general oversight of the Federal agency determined in accordance with §___.105. The oversight agency for audit:

(1) Shall provide technical advice to auditees and auditors as requested.

(2) May assume all or some of the responsibilities normally performed by a cognizant agency for audit.

(c) *Federal awarding agency responsibilities.* The Federal awarding agency shall perform the following for the Federal awards it makes:

(1) Identify Federal awards made by informing each recipient of the CFDA title and number, award name and number, award year, and if the award is for R&D. When some of this information is not available, the Federal agency shall provide information necessary to clearly describe the Federal award.

(2) Advise recipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements.

(3) Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this part.

(4) Provide technical advice and counsel to auditees and auditors as requested.

(5) Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.

(6) Assign a person responsible for providing annual updates of the compliance supplement to OMB.

(d) *Pass-through entity responsibilities.* A pass-through entity shall perform the following for the Federal awards it makes:

(1) Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.

(2) Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.

(3) Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.

(4) Ensure that subrecipients expending $300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.

(5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.

(6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

(7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with this part.

§___.405 Management decision.

(a) *General.* The management decision shall clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee action to repay disallowed costs, make financial adjustments, or take other action. If the auditee has not completed corrective action, a timetable for follow-up should be given. Prior to issuing the management decision, the Federal agency or pass-through entity may request additional information or documentation from the auditee, including a request for auditor assurance related to the documentation, as a way of mitigating disallowed costs. The management decision should describe any appeal process available to the auditee.

(b) *Federal agency.* As provided in §___.400(a)(7), the cognizant agency for audit shall be responsible for coordinating a management decision for audit findings that affect the programs of more than one Federal agency. As provided in §___.400(c)(5), a Federal awarding agency is responsible for issuing a management decision for findings that relate to Federal awards it makes to recipients. Alternate arrangements may be made on a case-by-case basis by agreement among the Federal agencies concerned.

(c) *Pass-through entity.* As provided in §___.400(d)(5), the pass-through entity shall be responsible for making the management decision for audit findings that relate to Federal awards it makes to subrecipients.

(d) *Time requirements.* The entity responsible for making the management decision shall do so within six months of receipt of the audit report. Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible.

(e) *Reference numbers.* Management decisions shall include the reference numbers the auditor assigned to each audit finding in accordance with §___.510(c).

Subpart E—Auditors

§___.500 Scope of audit.

(a) *General.* The audit shall be conducted in accordance with GAGAS. The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards shall be for the same fiscal year.

(b) *Financial statements.* The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

(c) *Internal control.* (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.

(2) Except as provided in paragraph (c)(3) of this section, the auditor shall:

(i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and

(ii) Perform testing of internal control as planned in paragraph (c)(2)(i) of this section.

(3) When internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness) in accordance with §___.510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.

(d) *Compliance.* (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.

(2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.

(3) For the compliance requirements related to Federal programs contained in the compliance supplement, an audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

(4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.

(e) *Audit follow-up.* The auditor shall follow-up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee in accordance with §___.315(b), and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.

(f) *Data Collection Form.* As required in §___.320(b)(3), the auditor shall complete and sign specified sections of the data collection form.

§___.505 Audit reporting.

The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

(a) An opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.

(b) A report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.

(c) A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.

(d) A schedule of findings and questioned costs which shall include the following three components:

(1) A summary of the auditor's results which shall include:

(i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);

(ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses;

(iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee;

(iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses;

(v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);

(vi) A statement as to whether the audit disclosed any audit findings which the auditor is required to report under §___.510(a);

(vii) An identification of major programs;

(viii) The dollar threshold used to distinguish between Type A and Type B programs, as described in §___.520(b); and

(ix) A statement as to whether the auditee qualified as a low-risk auditee under §___.530.

(2) Findings relating to the financial statements which are required to be reported in accordance with GAGAS.

(3) Findings and questioned costs for Federal awards which shall include audit findings as defined in §___.510(a).

(i) Audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) which relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by Federal agency or pass-through entity.

(ii) Audit findings which relate to both the financial statements and Federal awards, as reported under paragraphs (d)(2) and (d)(3) of this section, respectively, should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

§___.510 Audit findings.

(a) *Audit findings reported.* The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

(1) Reportable conditions in internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement. The auditor shall identify reportable conditions which are individually or cumulatively material weaknesses.

(2) Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement.

(3) Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than $10,000 for a type of compliance requirement for a major program. In reporting questioned costs, the auditor shall include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

(4) Known questioned costs which are greater than $10,000 for a Federal program which is not audited as a major program. Except for audit follow-up, the auditor is not required under this part to perform audit procedures for such a Federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than $10,000, then the auditor shall report this as an audit finding.

(5) The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for Federal awards.

(6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.

(7) Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with §___.315(b) materially misrepresents the status of any prior audit finding.

(b) *Audit finding detail.* Audit findings shall be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for Federal agencies and pass-through entities to arrive at a management decision. The following specific information shall be included, as applicable, in audit findings:

(1) Federal program and specific Federal award identification including the CFDA title and number, Federal award number and year, name of Federal agency, and name of the applicable pass-through entity. When information, such as the CFDA title and number or Federal award number, is not available, the auditor shall provide the best information available to describe the Federal award.

(2) The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation.

(3) The condition found, including facts that support the deficiency identified in the audit finding.

(4) Identification of questioned costs and how they were computed.

(5) Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified shall be related to the universe and the number of cases examined and be quantified in terms of dollar value.

(6) The possible asserted effect to provide sufficient information to the auditee and Federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.

(7) Recommendations to prevent future occurrences of the deficiency identified in the audit finding.

(8) Views of responsible officials of the auditee when there is disagreement with the audit findings, to the extent practical.

(c) *Reference numbers.* Each audit finding in the schedule of findings and questioned costs shall include a reference number to allow for easy referencing of the audit findings during follow-up.

§__.515 Audit working papers.

(a) *Retention of working papers.* The auditor shall retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report(s) to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the Federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and reports.

(b) *Access to working papers.* Audit working papers shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this part. Access to working papers includes the right of Federal agencies to obtain copies of working papers, as is reasonable and necessary.

§__.520 Major program determination.

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

(i) $300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed $300,000 but are less than or equal to $100 million.

(ii) $3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed $100 million but are less than or equal to $10 billion.

(iii) $30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed $10 billion.

(2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.

(3) The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When

a Federal program providing loans significantly affects the number or size of Type A programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

(4) For biennial audits permitted under §___.220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under §___.510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under §___.510(a)(3) and §___.510(a)(4), fraud under §___.510(a)(6), and audit follow-up for the summary schedule of prior audit findings under §___.510(a)(7) do not preclude the Type A program from being low-risk. The auditor shall consider: the criteria in §___.525(c), §___.525(d)(1), §___.525(d)(2), and §___.525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

(2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in §___.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in §___.525(b)(1), §___.525(b)(2), and §___.525(c)(1), a single criteria in §___.525 would seldom cause a Type B program to be considered high-risk.

(2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:

(i) $100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to $100 million in total Federal awards expended.

(ii) $300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than $100 million in total Federal awards expended.

(e) *Step 4.* At a minimum, the auditor shall audit all of the following as major programs:

(1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).

(2) (i) High-risk Type B programs as identified under either of the following two options:

(A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.

(B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.

(ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.

(3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.

(f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in §___.530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.

(g) *Documentation of risk.* The auditor shall document in the working papers the risk analysis process used in determining major programs.

(h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.

(i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.

(1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.

(2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

§___.525 Criteria for Federal program risk.

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

- (i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.
- (ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
- (iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.

(2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.

(3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

(2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

(2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or inter-

im regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or the provisions of contracts or grant agreements may increase risk.

(3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.

(4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

§___.530 Criteria for a low-risk auditee.

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with §___.520:

(a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.

(b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.

(c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.

(d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:

   (1) Internal control deficiencies which were identified as material weaknesses;

   (2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program; or

   (3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

Appendix A to Part ___—Data Collection Form (Form SF-SAC)

[Insert SF-SAC after finalized]

Appendix B to Part ___—Circular A-133 Compliance Supplement

Note: Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

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APPENDIX C

Illustrative Schedules of Expenditures of Federal Awards

Example Entity
Schedule of Expenditures of Federal Awards[1]
For the Year Ended June 30, 19X1[2]

Federal Grantor / Pass-Through Grantor / Program or Cluster Title	*Federal CFDA Number*[3]	*Pass-Through Entity Identifying Number*[4]	*Federal Expenditures*[5]
U.S. Department of Agriculture:			
Summer Food Service Program for Children—Commodities	10.559		$ 46,000
Total U.S. Department of Agriculture			$ 46,000
U.S. Department of Housing and Urban Development:			
Community Development Block Grant—Entitlement Grants (note 2)	14.218		$1,235,632
Section 8 Rental Voucher Program	14.855		800,534
Total U.S. Department of Housing and Urban Development			$2,036,166
U.S. Department of Education:			
Impact Aid	84.041		$ 372,555
Bilingual Education	84.288		28,655
Subtotal Direct Programs			$ 401,210
Pass-Through Program From:			
State Department of Education—Title I Grants to Local Educational Agencies	84.010	23-8345-7612	$1,239,398
Total U.S. Department of Education			$1,640,608
Total Expenditures of Federal Awards			$3,722,774

The accompanying notes are an integral part of this schedule.

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[1] To meet state or other requirements, auditees may decide to include certain nonfederal awards (for example, state awards) in this schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

[2] Additional guidance on the schedule is provided in chapter 5 which includes a discussion of the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds. Chapter 5 also includes a discussion of the auditor's responsibility for reporting on the schedule.

[3] When the CFDA number is not available, the auditee should indicate that the CFDA number is not available and include in the schedule the program's name and, if available, other identifying number.

[4] When awards are received as a subrecipient, the identifying number assigned by the pass-through entity should be included in the schedule.

[5] Circular A-133 requires that the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end be included in either the schedule or a note to the schedule. Although it is not required, Circular A-133 states that it is preferable to present this information in the schedule (versus the notes to the schedule). If the auditee presents noncash assistance in the notes to the schedule, the auditor should be aware that such amounts must still be included in part III of the data collection form.

Example Entity
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 19X1

Note 1. Basis of Presentation[6]

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity and is presented on the [*identify basis of accounting*]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [*general-purpose or basic*] financial statements.

Note 2. Subrecipients[7]

Of the federal expenditures presented in the schedule, Example Entity provided federal awards to subrecipients as follows:

Program Title	*Federal CFDA Number*	*Amount Provided to Subrecipients*
Community Development Block Grant—Entitlement Grants	14.218	$423,965

[6] This note is included to meet the Circular A-133 requirement that the schedule include notes that describe the significant accounting policies used in preparing the schedule.

[7] Circular A-133 requires the schedule of expenditures of federal awards to include, to the extent practical, an identification of the total amount provided to subrecipients from each federal program. Although this example includes the required subrecipient information in the notes to the schedule, the information may be included on the face of the schedule as a separate column or section, if that is preferred by the auditee.

Example Entity University
Schedule of Expenditures of Federal Awards[8]
For the Year Ended June 30, 19X1[9]

Federal Grantor / Pass-Through Grantor / Program or Cluster Title	*Federal CFDA Number*[10]	*Pass-Through Entity Identifying Number*[11]	*Federal Expenditures*[12]
Student Financial Aid—Cluster:			
U.S. Department of Education:			
Federal Pell Grant Program	84.063		$ 8,764,943
Federal Supplemental Educational Opportunity Grant	84.007		974,873
Federal Work-Study Program	84.033		575,417
Federal Perkins Loan Program (note 2)	84.038		1,548,343
Total U.S. Department of Education			$11,863,576
U.S. Department of Health and Human Services:			
Nursing Student Loans (note 2)	93.364		$ 823,582
Total U.S. Department of Health and Human Services			$ 823,582
Total Student Financial Aid			$12,687,158
Research and Development—Cluster:[13]			
U.S. Department of Defense:			
Department of Army	N.A.		$ 87,403
Office of Naval Research	N.A.		73,107
Subtotal Direct Programs			$ 160,510
Pass-Through Programs From:			
XYZ Labs—Effects of Ice on Radar Images	N.A.	4532	$ 11,987
Total U.S. Department of Defense			$ 172,497
National Science Foundation:			
National Science Foundation (note 3)	N.A.		$ 432,111
Pass-Through Programs From:			
ABC University—Atmospheric Effects of Volcano Eruptions	N.A.	Abc97-8	$ 25,987
Total National Science Foundation			$ 458,098
U.S. Department of Health and Human Services:			
National Institutes of Health	N.A.		$ 675,321
Administration on Aging (note 3)	N.A.		234,987
Subtotal Direct Programs			$ 910,308

[8] See footnote 1.

[9] See footnote 2.

[10] See footnote 3.

[11] See footnote 4.

[12] See footnote 5.

[13] For R&D, Circular A-133 requires that total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. This example illustrates the federal agency and major subdivision option.

Federal Grantor / Pass-Through Grantor / Program or Cluster Title	*Federal CFDA Number*[10]	*Pass-Through Entity Identifying Number*[11]	*Federal Expenditures*[12]
Pass-Through Programs From:			
ABC Hospital—Heart Research	N.A.	5489-5	$ 432,765
State Health Department—Food Safety Research	N.A.	SG673-45	123,987
Subtotal Pass-Through Programs			$ 556,752
Total U.S. Department of Health and Human Services			$ 1,467,060
Total Research and Development			$ 2,097,655
Other Programs:			
U.S. Department of Energy:			
Educational Exchange—University Lectures and Research	82.002		$ 17,823
Total U.S. Department of Energy			$ 17,823
U.S. Department of Education:			
TRIO Talent Search	84.044		$ 308,465
Safe and Drug-Free Schools and Communities	84.184		59,723
Subtotal Direct Programs			$ 368,188
Pass-Through Programs From:			
State Department of Education—Vocational EducationBasic Grant	84.048	874-90-5473	$ 3,115
State Department of Education—Tech-Prep Education	84.243	25-8594-2167	176,885
Subtotal Pass-Through Programs			$ 180,000
Total U.S. Department of Education			$ 548,188
Total Other Programs			$ 566,011
Total Expenditures of Federal Awards			$15,350,824

N.A. = Not Available

The accompanying notes are an integral part of this schedule.

Example Entity University
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 19X1

Note 1. Basis of Presentation[14]

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity University and is presented on the [*identify basis of accounting*]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [*general-purpose or basic*] financial statements.

Note 2. Loans Outstanding[15]

Example Entity University had the following loan balances outstanding at June 30, 19X1. These loan balances outstanding are also included in the federal expenditures presented in the schedule.

Cluster / Program Title	*Federal CFDA Number*	*Amount Outstanding*
Federal Perkins Loan Program	84.038	$1,268,236
Nursing Student Loans	93.364	$ 763,127

Note 3. Subrecipients[16]

Of the federal expenditures presented in the schedule, Example Entity University provided federal awards to subrecipients as follows:

Program Title	*Federal CFDA Number*	*Amount Provided to Subrecipients*
National Science Foundation	N.A.	$236,403
Administration on Aging	N.A.	$138,095

[14] See footnote 6.

[15] This note is intended to meet the Circular A-133 requirement that loans or loan guarantees outstanding at year end be included in the schedule.

[16] See footnote 7.

APPENDIX D

Illustrative Auditor's Reports

D.1. This appendix contains examples of the reports issued under GAAS, *Government Auditing Standards*, and Circular A-133 in various circumstances for a single audit. Also included are examples of the reports issued for a program-specific audit.

D.2. As discussed in chapter 10, reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a single audit (the basic elements of each of the recommended reports are discussed in chapter 10):

- An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards
- A report on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*
- A report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133

D.3. Furthermore, as discussed in chapter 11, this SOP recommends that the following reports be issued for a program-specific audit (see paragraph 11.10 for a discussion of the possible issuance of a separate report to meet the reporting requirements of *Government Auditing Standards*): (*a*) an opinion on the financial statement(s) of the federal program and (*b*) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under Circular A-133.

D.4. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee's situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

D.5. The following example auditor's reports illustrate the types of reports to be issued in selected situations. Chapters 10 and 11 of this SOP include discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements*.

D.6. The following is a list of the example reports in this appendix:

Example No.	*Title*
1	Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity
1a	Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization
2	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])
2a	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards (Reportable Instances of Noncompliance and Reportable Conditions Identified)*
3	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified]*)
3a	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Qualified Opinion on Compliance and Reportable Conditions Identified*)
4	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified*)
5	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified*)
6	Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133
6a	Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 *(Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])*

Example 1

Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity[1]

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,[2] issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [*date of report*] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.[3]

The accompanying schedule of expenditures of federal awards[4] is presented for purposes of additional analysis as required by U.S. Office of Management and

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[1] Auditors may also refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* for additional guidance on reporting on the general-purpose financial statements of a government.

[2] The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

[3] The following paragraph should be deleted if the schedule of expenditures of federal awards is not presented with the general-purpose financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. See footnotes 34 and 40 for additional guidance.

[4] If the auditor is reporting on additional supplementary information (for example, combining and individual fund and account group financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. The example reports in appendix A of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provide useful guidance.

Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the general-purpose financial statements. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.[5]

[*Signature*]

[*Date*]

[5] When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09–.11, .13, and .14).

Example 1a

Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization[6]

Independent Auditor's Report

[Addressee]

We have audited the accompanying statement of financial position of Example NFP as of June 30, 19X1, and the related statements of activities and cash flows[7] for the year then ended. These financial statements are the responsibility of Example NFP's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,*[8] issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Example NFP as of June 30, 19X1, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated *[date of report]* on our consideration of Example NFP's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.[9]

The accompanying schedule of expenditures of federal awards[10] is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.[11]

[Signature]

[Date]

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[6] Auditors may also refer to the AICPA Audit and Accounting Guide *Not-For-Profit Organizations* for additional guidance on reporting on the financial statements of a not-for-profit organization.

[7] If the not-for-profit organization is a voluntary health and welfare organization, this phrase should be modified to state "and the related statements of activities, functional expenses and cash flows."

[8] See footnote 2.

[9] See footnote 3.

[10] If the auditor is reporting on additional supplementary information (for example, a comparison of actual and budgeted expenses), this paragraph should be modified to describe the additional supplementary information. SAS No. 29 provides useful guidance.

[11] See footnote 5.

Example 2

Report on Compliance and on Internal Control Over Financial Reporting[12] Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])*[13]

[*Addressee*]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[14] We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,[15] issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.[16, 17]

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not neces-

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[12] See paragraph 4.12 for a description of internal control over financial reporting.

[13] The auditor should use the portions of examples 2 and 2a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 2a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 2a.

[14] Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

[15] See footnote 2.

[16] See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

[17] If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

sarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.[18]

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities.[19] However, this report is a matter of public record and its distribution is not limited.[20]

[*Signature*]

[*Date*]

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[18] If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

[19] If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]."

[20] If the report is not a matter of public record, this sentence should be deleted.

Example 2a

Report on Compliance and on Internal Control Over Financial Reporting[21] Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (*Reportable Instances of Noncompliance and Reportable Conditions Identified*)[22]

[*Addressee*]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[23] We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,*[24] issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*[25] and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-2 and 97-5*].[26]

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Example Entity's ability to record, process, summarize, and report financial data consistent with the

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[21] See footnote 12.

[22] See footnote 13.

[23] See footnote 14.

[24] See footnote 2.

[25] See footnote 16.

[26] If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "We also noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20 of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-1, 97-4, and 97-8*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.[27, 28]

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities.[29] However, this report is a matter of public record and its distribution is not limited.[30]

[*Signature*]

[*Date*]

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[27] If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, of the reportable conditions described above, we consider items [*list the reference numbers of the related findings, for example, 97-1 and 97-8*] to be material weaknesses."

[28] If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

[29] If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]." All references to the schedule of findings and questioned costs should also be removed, and instead, a description of the findings should be included in the report.

[30] See footnote 20.

Example 3

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 *(Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])*[31]

[*Addressee*]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards,*[32] issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-3 and 97-6*].[33]

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[31] The auditor should use the portions of examples 3 and 3a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 3a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 3a.

[32] See footnote 2.

[33] When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.[34]

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.[35]

[*Signature*]

[*Date*]

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[34] As noted in notes 3 and 9, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph as follows:

> Schedule of Expenditures of Federal Awards
> We have audited the [*general-purpose or basic*] financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. Our audit was performed for the purpose of forming an opinion on the [*general-purpose or basic*] financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the [*general-purpose or basic*] financial statements. Such information has been subjected to the auditing procedures applied in the audit of the [*general-purpose or basic*] financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the [*general-purpose or basic*] financial statements taken as a whole.
>
> Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Auditors should also refer to notes 5 and 11 for additional guidance.

[35] See footnote 20.

Example 3a

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Qualified Opinion on Compliance and Reportable Conditions Identified*)[36]

[*Addressee*]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards,*[37] issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [*list the reference numbers of the related findings, for example, 97-10*] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [*identify the type(s) of compliance requirement*] that are applicable to its [*identify the major federal program*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1.[38]

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[36] See footnote 31.

[37] See footnote 2.

[38] When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Circular A-133, the following sentence should be added: "The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-3 and 97-6*]."

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.[39, 40]

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.[41]

[*Signature*]

[*Date*]

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[39] See footnote 27.

[40] See footnote 34.

[41] See footnote 20.

Example 4

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 *(Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified)*

[*Addressee*]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards,*[42] issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [*identify the major federal program*] regarding [*identify the type(s) of compliance requirement*], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding Example Entity's compliance with the requirements of [*identify the major federal program*] regarding [*identify the type(s) of compliance requirement*], Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.[43]

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[42] See footnote 2.

[43] See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as *items* [*list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.[44, 45]

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.[46]

[*Signature*]

[*Date*]

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[44] See footnote 27.

[45] See footnote 34.

[46] See footnote 20.

Example 5

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 *(Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified)*

[*Addressee*]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,[47] issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [*list the reference numbers of the related findings, for example, 97-10, 97-11, and 97-12*] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [*identify the types of compliance requirements*] that are applicable to its [*identify the major federal program*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects, with the requirements referred to above that are applicable to [*identify the major federal program*]. Also, in our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.[48]

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[47] See footnote 2.

[48] See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items [*list the reference numbers of the related findings, for example 97-8 and 97-9*] to be material weaknesses.[49]

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.[50]

[*Signature*]

[*Date*]

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[49] See footnote 34.

[50] See footnote 20.

Example 6

Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133

Independent Auditor's Report

We have audited the accompanying schedule of expenditures of federal awards for the *[identify the federal program]* of Example Entity for the year ended June 30, 19X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.[51]

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,[52] issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of expenditures of federal awards referred to above[53] presents fairly, in all material respects, the expenditures of federal awards under the *[identify the federal program]* in conformity with generally accepted accounting principles.[54, 55]

[Signature]

[Date]

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[51] In many cases, the financial statements of the program will consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Circular A-133. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Also refer to paragraph 11.10 for a discussion of the possible necessity to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

[52] See footnote 2.

[53] If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

[54] The auditor should follow the guidance in SAS No. 62, *Special Reports* when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

[55] If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10), an additional paragraph should be added as follows: "In accordance with *Government Auditing Standards*, we have also issued our report dated *[date of report]* on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants."

Example 6a

Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133[56] (*Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified]*)[57]

[*Addressee*]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to [*identify the federal program*] for the year ended June 30, 19X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards,*[58] issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [*identify the federal program*] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [*identify the federal program*] for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-1 and 97-2*].[59]

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[56] This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide (see paragraph 11.4 for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

[57] If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in examples 3a or 5, accordingly. If reporting reportable conditions, including material weaknesses, the auditor should modify the internal control section of this report to be consistent with the wording used in example 3a.

[58] See footnote 2.

[59] See footnote 33.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on its [*identify the federal program*] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended for the information of the audit committee, management, [*specify legislative or regulatory body*], and the federal awarding agency and pass-through entity. However, this report is a matter of public record and its distribution is not limited.[60]

[*Signature*]

[*Date*]

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[60] See footnote 20.

APPENDIX E

Illustrative Schedule of Findings and Questioned Costs

Example Entity
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 19X1

Section I—Summary of Auditor's Results

Financial Statements

Type of auditor's report issued [*unqualified, qualified, adverse, or disclaimer*]:

Internal control over financial reporting:

- Material weakness(es) identified? ______ yes ______ no
- Reportable condition(s) identified that are not considered to be material weaknesses? ______ yes ______ none reported

Noncompliance material to financial statements noted? ______ yes ______ no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? ______ yes ______ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? ______ yes ______ none reported

Type of auditor's report issued on compliance for major programs [*unqualified, qualified, adverse, or disclaimer*]:[1]

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? ______ yes ______ no

Identification of major programs:[2]

CFDA Number(s)[3]	Name of Federal Program or Cluster[4]

[1] If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: "Unqualified for all major programs except for [*name of program*], which was qualified and [*name of program*], which was a disclaimer."

[2] Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

[3] When the CFDA number is not available, include other identifying number, if applicable.

[4] The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are only required to list the name of the cluster and not each individual program within the cluster.

Dollar threshold used to distinguish between type A and type B programs: $__________

Auditee qualified as low-risk auditee? _____ yes _____ no

Section II—Financial Statement Findings

[This section identifies the reportable conditions, material weaknesses, and instances of noncompliance related to the financial statements that are required to be reported in accordance with paragraphs 5.18 through 5.20 of Government Auditing Standards. *Auditors should refer to those paragraphs, as well as the reports content section of chapter 7 of* Government Auditing Standards, *for additional guidance on preparing this section of the schedule.*

Identify each finding with a reference number.[5] *If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that effects an entity as a whole, including its federal awards, would generally be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:*

- *Criteria or specific requirement*
- *Condition*
- *Questioned costs*
- *Context*[6]
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*[7]]

Section III—Federal Award Findings and Questioned Costs

[This section identifies the audit findings required to be reported by section 510(a) of Circular A-133 (for example, reportable conditions, material weaknesses, and instances of noncompliance, including questioned costs). Where practical, findings should be organized by federal agency or pass-through entity.

Identify each finding with a reference number.[8] *If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section*

[5] A suggested format for assigning reference numbers is to use the last two digits of the fiscal year being audited, followed by a numeric sequence of findings. For example, findings identified and reported in the audit of fiscal year 1997 would be assigned reference numbers of 97-1, 97-2, etc.

[6] Provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the universe of costs and/or the number of items examined and quantification of audit findings in dollars.

[7] See paragraphs 5.18 through 5.20 and 7.38 through 7.42 of *Government Auditing Standards* for additional guidance on reporting management's response.

[8] See footnote 5.

III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements would generally be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Information on the federal program*[9]
- *Criteria or specific requirement (including statutory, regulatory, or other citation)*
- *Condition*[10]
- *Questioned costs*[11]
- *Context*[12]
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*[13]]

[9] Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

[10] Include facts that support the deficiency identified in the audit finding.

[11] Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

[12] See footnote 6.

[13] To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

Appendix E

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Information Sources

Organization	General Information	Fax Services	Web Site
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077 Information about AICPA CPE programs is available through the AICPA by calling (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	*AICPA Home Page* The AICPA home page is currently located at http://www.aicpa.org
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		The FASB home page is currently located at http://www.fasb.org
U.S. Department of Education	Office of Inspector General U.S. Department of Education, Switzer Building, Room 4200 Washington, DC 20202 (202) 205-8238		The U.S. Department of Education, home page is currently located at http://www.ed.gov
U.S. Office of Management and Budget	Office of Administration Publications Office Room 2200 New Executive Office Building Washington, DC 20503 (202) 395-7332	*Twenty Four Hour Fax Hotline* (202) 395-9068 for certain Circulars and Standards (202) 395-9088 for speeches and press releases	The OMB home page is currently located at http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html

Organization	General Information	Fax Services	Electronic Bulletin Board Services
National Association of College and University Business Offices	One Dupont Circle Suite 500 Washington, DC 20036 (202) 861-2500 (202) 861-2583 (f)		The NACUBO home page is currently located at www.nacubo.org
National Health Council	1730 M Street, NW Suite 500 Washington, DC 20036 (202) 785-3910 (202) 785-5923 (f)		The National Health Council home page is located at http://www.healthanswer.com (click on "Health Organizations" and then click on "National Health Council")
Other			The *Rutgers Bulletin Board* on the World Wide Web includes various accounting related databases. The address for the home page is http://www.rutgers.edu/accounting/raw.html
U.S. General Accounting Office	U.S. Government Printing Office *Superintendent of Documents* Washington, DC 20401 (202) 783-3238 (202) 512-2250 (f) or U.S. GAO P.O. Box 6015 Gaithersburg, MD 20884 (202) 512-6000 (202) 258-4066 (f)		The GAO has a home page on the World Wide Web. The address is http://www.gao.gov

Appendix F

Schedule of Changes Made to Not-for-Profit Organizations

Reference	Change	Date
Preface (footnote 3)	Revised to reflect the issuance of SOP 98-2.	June, 1998
Chapter 1	Revised to reflect the issuance of recent authoritative guidance; Footnotes 7 and 8 deleted and subsequent footnote renumbered.	June, 1997
Paragraphs 1.24, 1.26, 1.27, 1.28, and 1.29	Revised to reflect the issuance of recent authoritative literature.	June, 1998
Paragraph 2.01	Revised to reflect the Single Audit Act Amendments of 1996.	June, 1997
Paragraph 2.01 (footnote *)	Added to reflect the issuance of SAS No. 83.	June, 1998
Paragraph 2.01 (footnote 2)	Revised to reflect the issuance of the revised OMB Circular A-133.	June, 1998
Paragraphs 2.26, 2.27, and 2.28	Revised to reflect the issuance of SAS No. 82; New footnote 5 added; Subsequent footnotes renumbered.	June, 1998
Paragraph 2.32	Revised to reflect the issuance of the revised OMB Circular A-133.	June, 1998
Paragraph 2.33	Revised to reflect the Single Audit Act Amendments of 1996; Conformed to the terminology used in SAS No. 78.	June, 1997
Paragraph 2.34	Conformed to the terminology used in SAS No. 78.	June, 1997
Paragraph 2.34	Reference changed from SOP 92-9 to 98-3; Renumbered footnote 9 revised to reflect the issuance of SOP 98-3.	June, 1998
Paragraph 2.38 (renumbered footnote 10)	Deleted.	June, 1997
Paragraph 2.44	Revised to reflect the issuance of SAS No. 85.	June, 1998
Paragraph 2.46	Revised to reflect the issuance of SOP 98-3.	June, 1998
Paragraph 5.05 and footnote 6	Added to reflect the issuance of FASB Interpretation No. 42; Subsequent paragraphs and footnotes renumbered.	June, 1997
Paragraph 8.24 (footnote 11)	Revised to reflect the issuance of FASB Statement No. 126.	June, 1997

Reference	Change	Date
Paragraph 8.29	Modified.	June, 1998
Paragraph 9.04	Revised to delete the reference to SOP 92-9.	June, 1998
Paragraph 13.04 (footnote 1)	Revised to reflect the issuance of the revised OMB Circular A-133.	June, 1998
Paragraph 13.17 (heading)	Footnote * added.	June, 1998
Paragraph 13.26	Reference changed from FASB Statement No. 14 to FASB Statement No. 131.	June, 1998
Paragraph 13.30 (footnote *)	Added.	June, 1998
Paragraph 14.15	Revised to reflect the Single Audit Act Amendments of 1996; Conformed to the terminology used in SAS No. 78.	June, 1997
Paragraph 14.15	Reference changed from SOP 92-9 to SOP 98-3.	June, 1998
Appendix A (footnote 2)	Added.	June, 1997
Appendix B	Deleted.	June, 1998
Appendix C	SOP 98-2 added.	June, 1998
Appendix D	SOP 98-3 added.	June, 1998

Glossary

agent. An entity acting for and on behalf of a principal, which may be either a resource provider or a beneficiary.

annuity gift. A transfer of assets to a not-for-profit organization in connection with a split-interest agreement that is in part a contribution and in part an exchange transaction. The organization accepts the contribution and is obligated to make periodic stipulated payments to the donor or a third-party beneficiary for a specified period of time, usually either a specified number of years or until the death of the donor or third-party beneficiary.

annuity trust. See *charitable remainder trust.*

board designated. See *designated net assets* and *endowment fund.*

charitable lead trust. A trust established in connection with a split-interest agreement, in which the not-for-profit organization receives distributions during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

charitable remainder trust. A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives specified distributions during the agreement's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust.

collections. Works of art, historical treasures, or similar assets that are (*a*) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (*b*) protected, kept unencumbered, cared for, and preserved, and (*c*) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

conditional promise to give. A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

contribution. An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

corpus. The principal amount of a gift or trust. Usually refers to the portion of a split-interest gift or an endowment fund that must be maintained over a specified period or in perpetuity.

designated net assets. Unrestricted net assets subject to self-imposed limits by action of the governing board. Designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses.

donor-imposed condition. A donor stipulation that specifies a future and uncertain event whose occurrence or failure to occur give the promisor a right of return of the assets it has transferred or releases the promisor from its obligation to transfer its assets.

donor-imposed restriction. A donor stipulation that specifies a use for the contributed asset that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws, or comparable documents for an unincorporated association. A restriction on an organization's use of the asset contributed may be temporary or permanent.

endowment fund. An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment, which is to provide a permanent source of income, or a term endowment, which is to provide income for a specified period. The portion of a permanent endowment that must be maintained permanently—not used up, expended, or otherwise exhausted—is classified as permanently restricted net assets. The portion of a term endowment that must be maintained for a specified term is classified as temporarily restricted net assets. An organization's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes referred to as funds functioning as endowment or quasi-endowment funds) to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets.

equity. See *net assets*.

functional classification. A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.

funds functioning as endowment. Unrestricted net assets earmarked by an organization's governing board, rather than restricted by a donor or other outside agency, to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets. The governing board has the right to decide at any time to expend the principal of such funds. (Sometimes referred to as quasi-endowment funds.) See also *designated net assets*.

fund raising activities. Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

funds held in trust by others. Resources held and administered, at the direction of the resource provider, by an outside trustee for the benefit of the organization, frequently in connection with a split-interest agreement or permanent endowment.

gift annuity. See *annuity gift*.

life income agreement. A form of split-interest agreement. See *annuity gift* and *charitable remainder trust*.

life tenant. One who possesses a life-use right to property, frequently used in connection with a split interest agreement.

natural expense classification. A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

net assets. The excess or deficiency of assets over liabilities, classified according to the existence or absence of donor-imposed restrictions.

net asset class(es). The classification of net assets based upon the existence or absence of donor-imposed restrictions. See also *permanently restricted net assets*, *temporarily restricted net assets*, and *unrestricted net assets*.

net investment (equity) in land, buildings, and equipment. The total carrying value (after accumulated depreciation) of all property, plant, and equipment, less directly related liabilities. This amount is exclusive of real properties that are held for investment purposes.

nonreciprocal transfer. A transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange.

not-for-profit organization. An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (FASB Concepts Statement No. 4, paragraph 7).

permanent restriction. A donor-imposed restriction that stipulates that resources be maintained permanently but permits the organization to use up or expend part or all of the income (or other economic benefits) derived from the donated assets.

permanently restricted net assets. The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (*c*) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

promise to give. A written or oral agreement to contribute cash or other assets to another entity. A promise to give may be either conditional or unconditional.

program services. The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs.

quasi-endowment. See *funds functioning as endowment*.

reclassifications. Transfers of amounts from one net asset class to another, usually as a result of the release or lapsing of restrictions.

remainder trust. See *charitable remainder trust*.

remainderman. The recipient of the corpus (remaining principal) of a trust upon termination.

restricted support. Donor-restricted revenues or gains from contributions that increase either temporarily restricted net assets or permanently restricted net assets. See also *unrestricted support*.

restricted net assets. Resources whose use is restricted by donors as contrasted with those over which the organization has complete control and discretion. Restricted net assets may be permanently or temporarily restricted.

spending-rate. The portion of total return on investments used for fiscal needs of the current period, usually used as a budgetary method of reporting returns of investments. It is usually measured in terms of an amount or a specified percentage of a moving average market value. Typically, the selection of a spending rate emphasizes (*a*) the use of prudence and a systematic formula to determine the portion of cumulative investment return that can be used to support fiscal needs of the current period and (*b*) the protection of endowment gifts from a loss of purchasing power as a consideration in determining the formula to be used.

split-interest agreement. Trust or other arrangements initiated by donors under which not-for-profit organizations receive benefits that are shared with either the donor or third party beneficiaries. These gifts include lead interests (see *charitable lead trust*) and remainder interests (see *charitable remainder trust*, *annuity gift*, and *annuity trust*).

stipulation. A statement by a donor that creates a condition or restriction on the use of transferred resources.

supporting activities. Activities other than program services. The primary supporting activities are management and general, fund raising, and membership development activities.

temporary restriction. A donor-imposed restriction that permits the donee organization to use up or expend the donated assets as specified and is satisfied either by the passage of time or by actions of the organization.

temporarily restricted net assets. The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (*c*) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

term endowment. A donor-restricted contribution that must be maintained for a specified term.

total return. A measure of investment performance that focuses on the overall return on investments, including interest and dividend income as well as realized and unrealized gains and losses on investments. Frequently used in connection with a spending-rate formula to determine how much of that return will be used for fiscal needs of the current period.

unconditional promise to give. A promise to give that depends only on passage of time or demand by the promisee for performance.

unrestricted net assets. The part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

unrestricted support. Revenues or gains from contributions that are not restricted by donors. See also *restricted support.*

voluntary health and welfare organizations. Organizations formed for the purpose of performing voluntary services for various segments of society. They are tax exempt (organized for the benefit of the public), supported by the public, and operated on a "not-for-profit" basis. Most voluntary health and welfare organizations concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare organizations include those not-for-profit organizations that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services.

If you would like additional copies of the *Not-for-Profit Organizations Audit & Accounting Guide,* or if you would like to automatically receive every annual update immediately upon its release, please call AICPA Member Satisfaction at 1-888-777-7077.

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Not-for-Profit Organizations Audit Risk Alert (ARA)
The Not-for-Profit Organizations ARA reminds you of the effect that current economic, regulatory, and professional developments can have on the audits you perform. The ARA will increase the efficiency of your audit planning process by giving you concise, relevant information that shows how current developments may impact your clients and your audits. It will also help you to control audit risk by highlighting important matters requiring special audit considerations.
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Developed by the AICPA's staff, this practice aid is an invaluable tool to both preparers and auditors of not-for-profit organization financial statements. This checklist has been updated to reflect recent AICPA and FASB pronouncements. The 1998 Checklist will be available Summer 1998.
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Brokers and Dealers in Securities (012180QB)
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Common Interest Realty Associations (012487QB)
Construction Contractors (012095QB)
Audits of Credit Unions (012058QB)
Audits of Employee Benefit Plans (012338QB)
Audits of Entities With Oil and Gas Producing Activities (012105QB)
Audits of Federal Government Contractors (012437QB)
Audits of Finance Cos. (012465QB)
Health Care Organizations (012438QB)
Audits of Investment Cos. (012362QB)
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